LEGISLATION RELATING TO TAX-MOTIVATED CORPORATE MERGERS AND ACQUISITIONS

HEARING

BEFORE THE

SUBCOMMITTEE ON SELECT REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS HOUSE OF REPRESENTATIVES

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LEGISLATION RELATING TO TAX-MOTIVATED CORPORATE MERGERS AND ACQUISITIONS

MONDAY, MAY 24, 1982

House of Representatives,
Committee on Ways and Means,
Subcommittee on Select Revenue Measures,
Washington, D.C.

The subcommittee met at 10:05 a.m., pursuant to notice, in room 1100, Longworth House Office Building, Hon. Fortney H. (Pete) Stark (chairman of the subcommittee) presiding.

Chairman Stark. The committee will commence.

I have the minority counsel's and the Treasury's permission to begin with my opening statement, and testimony of some of our colleagues in the Congress in an effort to accommodate those people who are returning to town.

The Subcommittee on Select Revenue Measures will today receive testimony from the administration, Members of Congress, and the interested members of the public on a number of bills, including a bill I recently introduced, H.R. 6295, dealing with the present tax treatment of corporate merges, acquisitions and reorgnizations.

Current law in this area is complex. In part that is a response to the complexity of the transactions the law seeks to govern. The law is often illogical, or the law produces unintended or inadvertent results.

Before going any further, I am sure that everybody in this room is equally well prepared to understand the law, and is familiar with many cases of how the law is applied, and I am assuming a familiarity with the principles of the present law.

Given those assumptions, I don't know if there is a need to go into a lengthy recital of the sections of the bill. I would like to issue a challenge to the witnesses. The subcommittee and the full committee won't be well served if we are to receive general criticism on questions of complexity or speculation as to the motive or intent of the author of any of the legislation or the committee. What this subcommittee needs today is a meaningful discussion of the fundamental principles addressing the provisions of these bills, particularly H.R. 6295.

One premise in H.R. 6295 is that a corporation should not be able to gain recognition rules for direct asset acquisitions by just structuring a transaction with the same economic result through the stock redemption route.

If this premise is unsound, tell us. Let's discuss it. Let's determine what the appropriate tax policy should be.

To take another example, we attempt to address directly the problem of takeover corporations receiving a step-up in basis for assets distributed by acquired subsidiaries in a liquidation where the acquired target's tax attributes are then used to shelter other income through consolidated returns. If this result is defensible as a matter of tax or economic policy, I invite the witnesses to make that case.

In sum, we are interested in developing sound tax policy in an almost overly complex but essential area of corporate takeovers. It will be greatly appreciated by the Chair, the staff and the members of the committee if the witnesses today would testify to provide constructive guidance and address the issues that we are attempting to raise in the bills before us today.

Without objection, I would ask at this point that the press release announcing the hearing be made a part of the record.

[The press release follows:]

[Press Release of Friday, May 7, 1982]

THE HONORABLE FORTNEY H. (PETE) STARK, CHAIRMAN, SUBCOMMITTEE ON SELECT REVENUE MEASURES, COMMITTEE ON WAYS AND MEANS, ANNOUNCES A PUBLIC HEARING ON LEGISLATION RELATING TO TAX-MOTIVATED COPORATE MERGERS AND ACQUISITIONS TO BE HELD ON MONDAY, MAY 24, 1982

The Honorable Fortney H. (Pete) Stark, Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives, today announced a public hearing on legislation relating to tax-motivated corporate mergers and acquisitions on Monday, May 24, 1982, at 10:00 a.m. The hearing will be held in the Committee's main hearing room, 1100 Longworth House Office Building. The lead-off witness at the hearing is expected to be the Honorable John E. Chapoton, Assistant Secretary of the Treasury for Tax Policy.

In announcing these hearings, Chairman Stark stated that "it appears that the tax rules relating to corporate takeovers may be encouraging non-economic mergers, acquisitions, and reorganizations. The subcommittee hopes to receive constructive testimony from economists, tax practitioners, and academicians on legislation to simplify and improve these rules."

BACKGROUND

It has come to the attention of the Subcommittee that an increasing number of corporate takeovers appear to be motivated by, or at least tailored to, the tax benefits which may be otained under persent law. Present law creates four types of problems.

First, under present law, corporate takeovers can be structured to achieve the same tax benefits to the buyer as a direct purchase of assets without incurring the tax consequences to the seller of recognition of gain and recapture of depreciation and the investment tax credit. This characteristic of present law violates established principles of tax policy, which require neutrality of treatment for essentially identical transactions, and require that the substance of a transaction, rather than the form, should determine the tax consequences.

Second, present law permits considerable discretion in the selection of the acquired corporation's assets for distribution, thus enabling the acquiring corporation to obtain a stepped-up basis and greater depreciation deductions. At the same time, favorable tax attributes of the acquired corporation can be retained for other assets.

Third, the present restrictions on the carryforward of losses or credits of a corporation after a change in ownership, and those scheduled to go into effect in 1964, are ineffective in deterring takeovers of loss corporations by profitable companies solely to obtain these favorable tax attributes. In addition, the investment incentives of the Economic Recovery Tax Act of 1981, and current economic conditions will increase the number of loss companies and thus, the potentially attractive takeover targets for profitable companies.

Finally, there is concern that many of these tax-related mergers, to the extent they are debt-financed, diminish the availability of credit for more productive purposes. In addition, resulting economic concentration could have serious implications for the nation's economy.

Several bills have been introduced to reduce or eliminate these tax incentives for corporate takeovers. The subcommittee will be examining the following bills:

H.R. 4562 (Mr. Dorgan of North Dakota, Mr. Benjamin, Mr. Smith of Iowa, Mr. Bonker, Mr. Kogovsek, Mr. Smith of Pennsylvania, Mr. Murphy, Mr. Harkin, Mr. Edgar, Mr. Vento, Mr. Sieberling, Mr. Dicks, Mr. Weiss, Mr. Patterson, Mr. Gejdenson, Ms. Oaker, Mr. Simon, Mr. Gore, Mr. Roemer, Mr. Jeffords, Mr. Dwyer, Mr. James Coyne, Mr. Williams of Montona and Mr. DeLugo)—To amend the Intenal Revenue Code of 1954 to deny all deductions for interest paid or incurred on loans in connection with an unfriendly takeover, or attempted takeovers, of a corporation.

H.R. 5517 (Mr. Evans of Iowa)—To amend the Internal Revenue Code of 1954 to deny the deduction for interest on indebtedness incurred to acquire corporations if the President determines that use of debt for corporate acquisitions should be discouraged.

H.R. 5719 (Mr. Harkin, Mr. Mitchell of Maryland, Mr. Murphy, Mr. Bedell, Mr. Seiberling, Mr. Williams of Montana, and Mr. Oberstar) To amend the Internal Revenue Code of 1954 to impose an excise tax on certain acquisitions of business entities.

H.R. 5855 (Mr. Stark)—To amend the Internal Revenue Code of 1954 to deny deductions for interest paid or incurred on loans in connection with an unfriendly takeover, or attempted takeover, of a corporation.

H.R. 6295 (Mr. Stark)—To amend the Internal Revenue Code of 1954 to reduce the tax incentives of corporate takeovers.

DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD

Individuals and organizations interested in presenting oral testimony at the hearing should submit their requests to be heard, by telephone, to Ms. Harriett Lawler, (202) 225-3627, to be followed by a formal written request, to John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. The initial telephone request must be recieved by the Committee not later than the close of business, Wednesday, May 19, 1982. Notification to those scheduled to appear will be made by telephone as soon as possible after the filing deadline.

It is urged that persons and organizations having a common position make every effort to designate one spokesman to represent them in order for the Subcommittee to hear as many points of view as possible. Time for oral presentation will be strictly limited, with the understanding that a more detailed statement can be submitted for the Subcommittee's review and for inclusion in the printed record of the hearing. This will afford more time for interrogation of the witnesses by the members of the Subcommittee. If it becomes necessry, the staff will group the witnesses into panels to expedite the hearing and will establish strict time limitations for each panelist.

The following is an outline of the procedure to be followed by organizations and individuals who may either want to appear and testify during the hearing or file a written statement for the printed record of the proceedings. All requests to be heard should also contain the following information:

1. The name of the witness, title, address, firm affiliation and/or organization he will represent (as well as a telephone number where his or her designated representative may be reached).
2. If appearing in an individual capacity, a list of any client at whose request or in whose employ the witness appears.
3. A topical outline or summary of comments and recommendations.

The above information should also be incorporated in the prepared statements to be presented in person as well as those filed for the record.

In order to assure the most productive use of the limited amount of time available to question hearing witnesses, witnesses scheduled to appear before the Subcommittee should comply with the following rules:

1. All witnesses must submit 75 copies of their prepared statement to the full Committee office, Room 1103, Longworth House Office Building, not later than noon Friday, May 21, 1982.
2. Witnesses should not read their written statements to the Subcommittee, but should instead limit their oral presentations to a summary of the points included in the statement.
3. Not more than five minutes will be allowd for the oral summary.

Failure to comply with these requirements may result in the witnesses being denied the opportunity to testify in person or being deferred until all other testimony is heard.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE

For those who wish to file a written statement for the printed record of the hearing, five copies are required and must be sumitted by the close of business, Friday, June 4, 1982, to John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. An additional supply of statements for the printed record may be furnished for distribution to the press and public if supplied to the Committee office the day before the hearing.

Chairman **STARK**. I welcome our first witness the Hon. Howard Metzenbaum, U.S. Senator from the great State of Ohio.

Senator Metzenbaum, it is a pleasure to have you this morning, you may proceed in any manner. Your full statement will be made part of the record and you may proceed in any manner you wish.

STATEMENT OF HON. HOWARD M. METZENBAUM, A U.S. SENATOR FROM THE STATE OF OHIO

Senator **METZENBAUM**. Thank you, Mr. Chairman. I will be brief because I know your agenda is heavy. I want to commend you for holding this hearing, and also for your introduction of the Corporate Takeover Act of 1982. H.R. 6285, I believe this legislation zeroes in on one of the many problems that concern the American people, and the Members of Congress as well. And that is how to best balance the budget.

I came out of the business world before I came to the U.S. Senate. And in the business community there are two aspects of making the business run well. Similarly there are two aspects of making the Government run well.

One is what you take in, and the other is what you spend. All of the consideration in recent weeks and months emanating from the White House has related to the question of what we spend, which is indeed a matter of major concern. But the fact is that if you don't take in enough, then no matter how great any spending cuts are, you won't be able to balance the budget.

The corporate tax loopholes and individual tax loopholes that existed prior to the enactment of the last tax bill, and those that were created as a consequence of that measure, have caused many people in this country to feel a strong sense of injustice. The American people aren't stupid. The American people read their paper and they watch the TV. When they hear that some corporations are getting by with paying no taxes, at the same time they are having difficulty in making ends meet, in putting food on the table for their families, in sending their kids to school, in buying clothing, or in paying rent, they perceive a real injustice in America.

I believe that what we are talking about this morning is one segment of that entire question. Therefore, I think this hearing is particularly important not because it involves such a great proportion of the entire tax revenue, but because an inequity exists, and it should not be permitted to continue.

We have seen corporate giants annex one another in recent months with dizzying speed, and one fact has become abundantly clear. The corporations and their high-priced lawyers are making a mockery of our tax laws, so that they may legally escape paying hundreds of millions and perhaps billions of dollars in taxes.

Now, this administration has turned its back on the whole question of corporate takeovers. It really doesn't care if the antitrust laws are violated. And I believe that the man who heads the Antitrust Division really should not be heading that division. He should resign, because he doesn't believe in the antitrust laws as they have been interpreted by the Supreme Court of the United States over a period of many years.

So we now see a whole wave of corporate takeovers. United States Steel buys Marathon Oil, Atlantic Richfield buys Anaconda, American Express buys Shearson Loeb Rhodes, and the mergers go on and on and on and on.

Why? Because our current tax system promotes and subsidizes these and dozens of other corporate takeovers. Each merger doesn't add to the health of the American economy but each ties up precious capital. Mergers help to keep interest rates high, and reduce the funds available for job-creating small business expansion and housing production.

There was a time in our history when all corporate takeovers were financed by using stock for stock exchanges. But then the price-earnings ratio went down with respect to many companies that didn't work out so well. As a result, money became a cheaper commodity than the use of stock. You would think that out of all of these mergers we would get something, but the fact is that few of these mergers are beneficial.

They don't improve management, efficiency, or productivity. They don't create new jobs. All they do is provide the companies involved with lucrative and unearned tax breaks. And as a matter of fact we find many situations where mergers that took place in yesteryear are now being reversed, and the people who formerly ran the companies are now buying them back at a small proportion of what was paid for them originally.

At a time when the Reagan administration is proposing cuts in social security, child nutrition, student loans, medicaid, and so many other human service programs, frankly, Mr. Chairman, I don't believe we can or should subsidize economically destructive mergers.

It is no secret that today we have an administration which has done little to deter corporate mergers, and even less to enforce the existing antitrust laws. Yet even this administration, through its Assistant Secretary of the Treasury, said in recent testimony before the Senate Finance Committee that: "Tax-motivated mergers serve no economic purposes, but lead to a greater concentration of economic power."

I couldn't agree more. I am only sorry that there isn't more implementation of that statement by the administration at every level.

The administration's only major defense for the safe harbor leasing provision enacted last year has been its belief that it curbs tax-motivated mergers. I don't share that belief, and I don't think that the facts would bear that out. I don't understand how it would ever make sense to attack tax-motivated mergers by creating a new multibillion dollar corporate tax loophole. Instead, I believe it is far more sensible to simply eliminate or modify the very provisions that create incentives to merge.

Last week I introduced legislation that parallels yours. It would eliminate two loopholes that promote tax-motivated mergers. The first of these deals with the provision of the Internal Revenue Code which presently allows a firm acquiring another company to avoid recapture by the Treasury of excessive depreciation deductions, and investment tax credits previously taken by the target company.

The United States Steel-Marathon Oil merger gives a striking example of how the recapture loophole works. In all honesty, I was opposed to the Mobil-Marathon merger. I didn't think Mobil ought to be gobbling up this Ohio company. I didn't think it was good for the American economic picture. I didn't think it was good for our energy needs, and I particularly didn't think it was good for Findlay, Ohio, and the State of Ohio.

When United States Steel came in as the white knight, I looked favorably upon their coming in instead of Mobil, but I didn't really think that anybody ought to be gobbling up Marathon. I thought the company was doing pretty well on its own. But I didn't know at that time, and I don't believe the American people subscribe to the idea, that United States Steel should have been able to save $400 million in that kind of a takeover by reason of a tax loophole.

One of Marathon's most valuable assets has been well known and recognized as the rich Yates oilfield. Marathon, like other oil companies, used a variety of Internal Revenue Code provisions to reduce its tax burden, chiefly investment tax credits, accelerated depreciation and intangible drilling cost deductions.

Normally, the acquisition of Marathon by United States Steel would trigger the code's recapture provision, a method devised by Congress to enable the Treasury to recover all or a portion of the excess depreciation taken on an asset at the time of its sale. But the loophole in question allows the new United States Steel-Marathon entity to avoid recapture, a pretty clever mechanism.

United States Steel accomplished this by purchasing the Yates Field from Marathon. United States Steel was then able to increase the depreciation deductions in the oilfield, since the property's present value is greater, and therefore the tax base is greater.

By filing a single tax return for the merged companies, known as a consolidated return, United States Steel is thus able to defer recapture of Marathon's excess depreciation, and totally avoid recapture of Marathon's investment tax credits. According to United States Steel's prospectus on the merger, that will save United States Steel $400 million in taxes in the first year alone.

There isn't one reason under the Sun why the American people ought to be subsidizing that merger to the extent of $400 million. And the $400 million that goes out the window has to be paid by somebody else. I now sit on a budget committee that is talking about raising taxes, and they are not talking about going after this type of thing.

No, they are talking about doubling liquor taxes, doubling beer taxes, doubling wine taxes, doubling gasoline taxes, doubling telephone taxes. They are talking about taxing unemployment insurance. They are talking about a new $5 a barrel import fee for oil that comes into this country, which would mean that every oil company in this country would be able to pick up another $5 per barrel on domestic production. So nobody is talking in that committee about really closing down some of these loopholes.

The second loophole to which this bill is addressed involves the tax treatment of capital gains realized by a firm which redeems its stock in exchange for appreciated assets. What does that mean? The classic case study is provided by Mobil Oil's acquisition of Esmark's oil subsidiary, Vickers Petroleum Energy Corp. Here is how the deal works. Pursuant to an understanding made in advance, Mobil bought enough shares of Esmark to equal the agreed purchase price. Esmark then turned around and redeemed its shares from Mobil in exchange for the stock of Vickers.

Congress has recognized the potential in such transactions for abuse. In 1969 Congress enacted a provision which requires a corporation to pay tax on the profit earned when it distributes appreciated property in order to redeem stock, but for whatever reason, and I would guess there were some able lobbyists at work, Congress at the same time enacted seven exceptions to this general rule.

One of these exceptions allows the transfer to be tax free if the appreciated property is the stock of a subsidiary 50 percent or more owned by the redeeming corporation. All the tax lawyers needed to know is that there was a way around the general rule. That exception offers corporations an opportunity to continue the very sheltering activity that Congress intended to halt.

Robert Wilkins, a partner with Peat, Marwick, Mitchell & Co., described the transaction this way in a Forbes magazine inteview:

> After the deal for the oil properties has already been struck and the price agreed upon, Esmark said, "Look Mobil, you go out and tender for whatever portion of my stock the subsidiary is worth. Then, as soon as you get the stock, we will turn over the oil operation to you in exchange for the stock."

That is a pretty neat and tidy arrangement. In this case it was worth an estimated $100 million in tax savings to Esmark that the people of this country will be called upon to make up in some other kind of tax. In the transaction involving Dome Petroleum and Conoco Oil Co., Dome saved an estimated $250 million through the same procedure, again the burden to be paid by the American taxpayers.

In International, Inc., and American Home Products, each used a similar tactic to escape taxes in deals involving Canadian Utilities, Ltd., and the Sherwood Medical Group, respectively.

Mr. Chairman, laws like these give corporations an incentive to merge. The current merger madness is the price we pay for them. Rather than seeking mergers to improve efficiency, to better serve consumers, to improve productivity, or to create jobs, corporations are literally searching for tax shelters. What an unbelievable waste of investment capital, and what a drain on a Federal budget that is starved for revenue. We have already seen that this administration cares little about enforcing our antitrust laws designed to prevent anticompetitive mergers. We should at least eliminate those laws that are destructive of the free enterprise system.

Mr. Chairman, I believe that the failure to enforce our antitrust laws and the reality of tax subsidization of these mergers really does a great disservice to the entire free enterprise system. And it saddens me much that those who go out on the political hustings and make the greatest speeches about the free enterprise system and the need to defend it, are the very ones who here in the Congress resist most arduously the effort to change those laws.

If we truly believe in the free enterprise system, then we must enforce our antitrust laws. And if we truly believe in equity, fairness, and justice, then we must eliminate these tax loopholes that cause such inequities.

Mr. Chairman, I thank you for the opportunity to appear.

[The prepared statement follows:]

STATEMENT OF HON. HOWARD M. METZENBAUM, A U.S. SENATOR FROM THE STATE OF OHIO

Mr. Chairman, thank you for giving me the opportunity to testify on H.R 6295, "The Corporate Takeover act of 1982."

As we have watched corporate giants annex one another with dizzying speed in recent months, one fact has become abundantly clear: the corporations and their high-priced lawyers are making a mockery of our tax laws to legally escape paying hundreds of millions, and perhaps, billions, of dollars in taxes.

U.S. Steel bought Marathon Oil; Atlantic Richfield bought Anaconda; American Express bought Shearson Loeb Rhodes; and the merger mania goes on and on.

Why? Because our current tax system promotes and subsidizes these and dozens of other corporate taxovers. Each merger ties up precious capital, helping to keep interest rates high and reducing the funds available for job-creating small business expansion and housing production.

You would think we would get something out of all this. But the fact is that few of these mergers are beneficial. They do not improve management, efficiency or productivity. They do not create new jobs. All they do is provide the companies involved with lucrative and unearned tax breaks.

At a time when the Reagan Administration is proposing cuts in Social Security, child nutrition, student loans, Medicaid and other human service programs, I do not believe we can or should subsidize economically destructive mergers.

It is no secret that we have today an Administration which has done little to deter corporate mergers and even less to enforce existing antitrust laws. Yet, even the Assistant Secretary of the Treasury said in recent testimony before the Senate Finance Committee that, "Tax-motivated mergers . . . serve no economic purposes, but . . . lead to a greater concentration of economic power."

Mr. Chairman, I couldn't agree more. Unfortunately, though, the Administration's only major defense for the "Safe Harbor Leasing" provision enacted last year has been its belief that it curbs tax-motivated mergers. I do not share this belief. And I do not understand how it would ever make sense to attack tax-motivated mergers by creating a new, multi-billion dollar corporate tax loophole. Instead, I believe it is far more sensible to simply eliminate or modify the very provisions that create the incentives to merge.

Last week, I introduced legislation similar in content, and identical in purpose, to H.R. 6295 My bill, S. 2547, would eliminate two loopholes that promote tax-motivated mergers.

The first of these deals with a provision of the Internal Revenue Code which presently allows a firm acquiring another company to avoid "recapture" by the Treasury of excessive depreciation deductions and investment tax credits previously taken by the target company.

The United States Steel-Marathon oil merger gives a striking example of how the recapture loophole works.

Over the years, one of Marathon's most valuable assets has been the rich Yates oilfield. Marathon has, like other oil companies, used a variety of Internal Revenue Code provisions to reduce its tax burden, chiefly investment tax credits, accelerated depreciation and intangible drilling cost deductions.

Normally, the acquisition of Marathon by United States Steel would trigger the Code's recapture provision, a method devised by Congress to enable the Treasury to recover all or a portion of the excess depreciation taken on an asset at the time of its sale.

But the loophole in question allows the new United States Steel-Marathon entity to avoid recapture. This was accomplished by U.S. Steel's purchasisng the Yates field from Marathon. United States Steel was then able to increase the depreciation deductions in the oil field since the property's present value is greater, and therefore the tax basis is greater. By filing a single tax return for the merged companies, known as a consolidated return, United States Steel can defer recapture of Marathon's excess depreciation and totally avoid recapture of Marathon's investment tax credits.

This procedure, according to the United States Steel prospectus on the merger, would save $400 million in taxes in the first year alone!

That may be good for United States Steel and for other acquiring companies, but it most certainly is not good for other business and individual taxpayers who must ultimately make up the revenue given away via tax provisions like this one.

The second loophole to which this bill is addressed, involves the tax treatment of capital gains realized by a firm which redeems its stock in exchange for appreciated assets.

What does that mean? The classic case study is provided by Mobil Oil's acquisition of Esmark's oil subsidiary, Vickers Petroleum Energy Corporation.

Here's how the deal worked:

Pursuant to an understanding made in advance, Mobil bought enough shares of Esmark to equal the agreed purchase price. Esmark then turned around and redeemed its shares from Mobil in exchange for the stock of Vickers.

Congress has recognized the potential in such transactions for abuse. In 1969, Congress enacted a provision which requires a corporation to pay tax on the profit earned when it distributes appreciated property in order to redeem stock.

But for whatever reason, Congress at the same time enacted seven exceptions to this general rule. One of these exceptions allows the transfer to be tax-free if the appreciated property is the stock of a subsidiary, 50-percent-or-more owned by the redeeming corporation. This exception offers corporations an opportunity to continue the very sheltering activity that Congress intended to halt.

Robert Wilkins, a partner with Peat, Marwick, Mitchell and Co. described the transition this way in a Forbes magazine interview:

"After the deal for the oil properties has already been struck and the price agreed upon, Esmark said, 'Look Mobil, you go out and tender for whatever portion of my stock the subsidiary is worth. Then, as soon as you get the stock, we will turn over the oil operation to you in exchange for the stock.' "

A pretty neat and tidy arrangement. In this case, it was worth an estimated $100 million in tax savings to Esmark. In the transaction involving Dome Petroleum and Conoco Oil Company, Dome saved an estimated $250 million through the same procedure IU International, Inc. and American Home products each used a similar tactic to escape taxes in deals involving Canadian Utilities, LTD., and the Sherwood Medical Group respectively.

Mr. Chairman, laws like these give corporations an incentive to merge. The current merger madness is the price we pay for them. Rather than seeking mergers to improve efficiency, to better serve consumers, to improve productivity or to create jobs, corporations are literally searching for tax shelters. What a waste of investment capital. And what a drain on a federal budget that is starved for revenue.

We have already seen that this Administration cares little about enforcing our antitrust laws designed to prevent anti-competitive mergers. We should at least eliminate some of the laws that are destructive to our free enterprise system.

I commend the Chairman of this Committee for taking the initiative in the House to close these loopholes, and I intend to work to the same end in the Senate.

Chairman **Stark**. Senator, thank you very much for that articulate and accurate description of the many problems that this legislation is going to attempt to address.

I notice that in the change of command in the other body, the Subcommittee on Antitrust Legislation, which you formerly chaired, was abolished. So much for antitrust enforcement.

I also wanted to add that in the May 17 issue of Tax Notes, not only do corporate lawyers, legislators and everybody else file loopholes, but a law student also found a loophole that he complained to the Treasury about in the liquidation reincorporation doctrine. That means that the public is apt to find them wherever they look.

I want to thank you for joining us this morning.

Senator **Metzenbaum**. Thank you very much.

Chairman STARK. Mr. Heftel—I want to see if my colleague from Hawaii who has joined us wishes to say anything.

Mr. HEFTEL. Thank you for your testimony.

Chairman STARK. Our next witness is our good friend and colleague, Neal Smith. I would be remiss if I didn't refer to him as Mr. Small Business. I must point out that according to a recent MIT study, approximately 66 percent of all new jobs are provided by businesses with 20 or fewer employees. These small businesses tend to be a little less efficient than big businesses, so that in their enterpreneuring they tend to create a few more jobs. They also tend to be in the vanguard of innovativeness. Your work in that field over the years has been well known. I welcome you here and look forward to hearing your testimony.

Without objection, your entire statement will be made part of the record. You may proceed in any manner you wish.

STATEMENT OF HON. NEAL SMITH, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF IOWA

Mr. SMITH. Thank you for the opportunity of appearing this morning.

I am a cosponsor of H.R. 4562, which would deny all income tax deductions for interest paid or incurred on loans in connection with an unfriendly takeover, or attempted takeover, of a corporation. I am fully supportive of this measure and would urge that the subcommittee even consider expanding it to deny interest deductions on loans for any takeover, whether friendly or unfriendly.

One of the primary factors which contributed to the greatness of this country is competition. Unfortunately, in recent years the Government itself has encouraged a reduction in competition. There was a dramatic increase last year in the number of large, hostile takeovers. They totaled a value of $82.6 billion, of which 12 transactions were valued over $1 billion each and 101 additional ones were valued at more than $100 million each.

I believe there are two major reasons for this drastic increase in mergers: First, although outside the jurisdiction of your committee, is the policy of the Justice Department which not only is no longer concerned with vertical mergers but also a Department spokesman has testified that they may even intervene on behalf of defendants in private antitrust enforcement actions; and second, is our tax laws which assist in financing takeovers and penalize the purchase of a smaller business. Although I am pleased by your decision to address the interest deductibility question, I believe that the entire pro merger climate of our tax laws must be considered rather than simply the interest deductibility segment of it. There are at least two other areas intertwined with this issue and I urge your consideration of them as well.

First, I urge that you keep in mind the encouragement of mergers when you consider the administration's proposal to impose a minimum tax on corportations. Many small forms are operating at a loss and the imposition of a minimum tax on them would drive them out of business faster. More small firms would then sell out to a big frim which could take advantage of the tax losses. If a minimum corporate income tax is considered, I urge you to provide an exemption for smaller firms.

Second, and of even more importance, is a provision in other legislation now pending before the committee, section 210 of H.R. 11, which I introduced last year. My proposal would defer recognition of capital gains on the sale of a small business if the proceeds are reinvested in another small business within 18 months, similar to the current tax treatment for sale and acquistion of a new primary residence.

Under existing law, if a successful small business owner sells for cash to another person, family, or group, there is an immediate recognition of income for tax purposes and a tax must be paid. Therefore, if a small business owner sells the business for cash and pays taxed on that gain, he has considerably less left to invest elsewhere. However, if he exchanges shares of stock in the small business for shares of stock in a corporation, the recognition of gain is delayed and there is no tax due immediately. If it is publicly held, easily sold stock, he can sell in years when his income is lower or at least spread out the recognition of gain, or he can hold the amount of stock and own more than the would have had he sold to a smalll business and bought stock with the amount left after taxes. This results in a seller requiring the small business purchaser for cash to pay a much larger price. For example, in the stiuation above, a large publicly traded corporation which offered $85,000 in stock might be a more attractive buyer than an individual offering $100,000 in cash. Thus, the existing tax law penalizes those which are not so acquired.

A capital gains rollover provision, such as the one contained in H.R. 11, would place reinvestment in small business on a par with the current tax deferral treatment for exchanges of stock in large businesses. Such a rollover provision would help eliminate part of the current bias in the tax code that favors mergers and acquisitions which tend to draw capital out of the small business sector. Also it would, as a result, help retain capital in the small business sector and slow the trend toward concentration and absorption of small businesses by conglomerates.

The revenue loss estimate for this rollover provision is small (prior to the reduction in the maximum capital gains tax in ERTA, the cost was about $100 million annually and now it would be even less) and the long term difference would be very small. Such a deferral would help retain and attract new capital to the small business sector of our economy by providing small businesses the same incentive to sell and reinvest in other small businesses as they currently have to merge with large publicly traded companies in tax-free reorganizations and exchanges of stock. The deferral of taxed for rollovers of investments affecting small business was voted the number seven priority by the delegates to the White House Conference on Small Business in 1980. I urge approval of H.R. 11.

I again thank you for the opportunity to testify this morning and would be pleased to respond to any questions.

Chairman **Stark**. Neal, thank you very much for your statement, and your interest in the small business community. It was your interest in the mergers that prompted us to look more thoroughly into this matter. I appreciate your testimony.

Mr. **Heftel.** One question, Neal. When you speak of an unfriendly takeover, how would you characterize that in terms of the individual or groups to whom the attempt to take over is considered unfriendly?

Mr. **Smith.** I think it is almost impossible to define because I personally know some situations where the stockholders think it is friendly and the management think it is unfriendly, and it is almost impossible.

I just think that really we should not permit tax deductions for interest on loans to acquire another company. I understand Canada doesn't permit acquisitions with borrowed money, whether it is friendly or unfriendly.

It seems to me it is almost contrary to the theory of establishing seperate entities called corporations and giving them the status of a "person" that has worked so well in this country, that people should be able to combine and put up risk capital and have a separate business.

That has helped this country a great deal, but they are not putting up additional risk capital when they borrow the money in an existing corporation to acquire another one.

Mr. **Heftel.** On the other hand, you would perhaps agree then that the distinction between friendly and unfriendly may not be desirable in view of the fact that an unfriendly takeover could be unfriendly to a management group, which in turn would not be in the best interest of a majority of the stockholders.

Mr. **Smith.** I would say that is essentially true, especially in a very successful corporation; the management may not want a conglomerate to take it over. They don't want to be under somebody else, but the stockholders may think it is a good time to make a good profit and want to sell. They would consider the proposal friendly.

Mr. **Heftel.** Thank you very much, Neal. Thank you for your testimony.

Chairman **Stark.** Thank you for your testimony, Neal. We appreciate it.

Our next witness is Hon. John Seiberling, from Ohio, a gentleman who is well acquainted with the antitrust provisions of our laws.

We look forward to your testimony, John. It will appear in its entirety in the record, and you may proceed in any manner you see fit.

STATEMENT OF HON. JOHN F. SEIBERLING, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OHIO

Mr. **Seiberling.** Thank you, Mr. Chairman. I will attempt to just hit the highlights.

Let me first of all commend you for calling these hearings on the relation between tax policies and corporate mergers and acquisitions. In my opinion, they are long overdue.

I have been a member of the House Judiciary Subcommittee on Monopolies for over 11 years. I was also a practicing antitrust lawyer for 21 years before coming to Congress.

Let me say I have utilized these provisions in the tax laws many times in helping my clients effectuate corporate mergers. They will pay the highest fee to the best attorneys and the best accountants in the country, even if those fees amount to millions of dollars, because the tax savings alone, if the merger is properly handled, amount to many times that amount.

I certainly subscribe to the testimony that has just been offered by Senator Howard Metzenbaum and Congressman Neal Smith. They are right on target.

Although on their face the tax laws are neutral with respect to corporate size, in fact they seem to have worked to foster mergers and acquisitions. I don't think that such an inherent bias in the tax code is a good thing for the country or for the economy or for the free enterprise system.

I am not going to go into the details of why further concentration is bad. It is outlined in my prepared statement. But let me simply say, because it is bad for our economy and for our free enterprise system, it is time we removed the pro-merger bias from the tax code.

One step in this direction would certainly be to enact the proposals put forward in bills that you have introduced, Mr. Chairman, along with Congressman Dorgan, to deny deductions for interest paid or incurred on loans to finance takeovers.

I don't know why we should limit them to unfriendly takeovers. It seems to me to the extent borrowed money is used to take over other corporations, we should be discouraging such takeovers and simply deny the interest deduction.

I don't think I need to say anything more about that, except that there were about $30 to $38 billion in merger-related bank loans last year, making it difficult for individuals to get loans and forcing them to pay high interest rates when they do.

This tied up a great deal of capital for months at a time, and is one of the reasons for the tight capital situation and the high interest rates.

A second step I think Congress should take would be to change the tax treatment of retained earnings. The tax code now creates incentives that help an acquiring firm buy another by using its own accumulated earnings.

When dividends are distributed to shareholders, they are treated as ordinary income, but retained earnings of a corporation or increases in the value of its assets are not taxed as income to the shareholders, of course, until he sells his stock. Then they are taxed as capital gain at a much lower rate.

So, the tax law encourages corporations to retain earnings rather than distribute them to shareholders and encourages them to acquire corporations with high book value for the same reasons.

The pressure to buy is compounded by the desire of the shareholders to increase the net worth of the corporation through acquisition so that they may enjoy the advantages of capital gains over ordinary income.

One solution to this problem would be to provide that in the event of a merger the portion of gain represented by the increase in book value resulting from the acquisition be taxed to the shareholder as ordinary income instead of capital gain.

Under this proposal, purchasing company shareholders would pay ordinary income taxes at the end of their tax year on the portion of the increase in the book value of their stock which can be attributed to the purchase of the subsidiary or its assets.

I recognize that there are problems associated with reaching a fair evaluation of the net effect of the merger on the book value of the acquiring company's stock. However, these are accounting questions of the type that are handled routinely in corporate financial administration.

Questions will arise as to the proper tax treatment if the acquisition reduces book value, as in cases where the acquired company has a negative book value. In such cases, fairness may well require recognizing losses as well as gains for stockholders, but of course sometimes a loss corporation is a fair target for acquisition and the desire to acquire losses can encourage incentives or can give incentives to corporate acquisitions.

So, I would suggest that that would need to be looked at very carefully.

In summary, Mr. Chairman, it is high time we eliminate these incentives to mergers and acquisitions that now exist in our tax code, and I commend you for starting that process in motion.

[The prepared statement follows:]

STATEMENT OF HON. JOHN F. SEIBERLING, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OHIO

Mr. Chairman, I commend you for calling these hearings to examine the relationship between tax policy and corporate mergers and acquisitions.

I have been a member of the House Judiciary Subcommittee on Monopolies for over 11 years. I was also a practicing antitrust lawyer for 21 years before coming to Congress. So I have looked at the competitive structure of industry, and particularly the problem of mergers and acquisitions, from the traditional antitrust law angle for some time. And while obviously it is necessary and important to view it from that perspective, I have also come to realize that federal tax policy also has a great influence on industrial concentration and the merger movement.

Although on their face the tax laws are neutral with respect to corporate size, in fact they seem to have worked to foster mergers and acquisitions. I don't think that such an inherent bias in the tax code is a good thing. For instance, one danger posed by increased concentration is monopolistic pricing. Economists have long recognized that the price and production decisions of monopolists are not in society's long-run interests. Instead of producing the quantity of goods which minimizes his average costs and then charging the lowest cost consistent with earning a normal profit, the monopolist, who doesn't have to worry about losing customers to another supplier, will restrict his production and make up for lower revenues through higher per-unit prices. Economists call the loss to society which results from monopoly behavior "deadweight loss."

The benefits of free competition are jeopardized by unbridled economic concentration. Cross-subsidization and reciprocal selling are abilities that ae especially available to large profit-centered conglomerates which can, if exercised, do harm to the vigor of competition.

Sometimes mergers do produce efficiencies, but frequently, they do not. Some companies grow so large that they cannot effectively integrate and recombine managerial talent. Other companies find that variant provisions of their collective bargaining agreements or basic differences in operating methods cause much greater problems than ever expected. And business history is full of examples of corporate mergers which damage the efficiency of the acquired company because the acquiring firm didn't understand the new business.

Beyond these economic and business concerns, there are societal and political problems posed by mergers. The current merger trend ties up huge amounts of capital, distracts managerial focus away from internal growth, transfers control of local business to distant cities, and provides huge corporate entities with overwhelming influence in the political arena.

For these reasons, I think we need to remove the pro-merger bias from the tax code. One step in this direction would be to enact the proposal put forward in bills introduced by Congressmen Dorgan and Stark to deny deductions for interest paid or incurred on loans to finance takeovers. Current law allows a deduction for corporate interest incurred to finance most acquisitions. An established company may deduct the interest on the money it borrows to buy another company and then use the target company's accumulated earnings to pay the remaining after-tax costs of the merger. Given that there were about $30 billion to $38 billion in merger-related bank loans last year, making it difficult for individuals to get loans and forcing them to pay high interest rates when they do, I think that Congress should replace this rule with one that is neutral and offers less inducement to merger activity.

A second step I think Congress should take would be to change the tax treatment of retained earnings. The tax code now creates incentives that help an acquiring firm buy another by using its own accumulated earnings.

When dividends are distributed to shareholders, they are treated as ordinary income. But retained earnings of the corporation, or increases in the value of its assets, are not taxed as income to the shareholder until he sells his stock. At that time, if he has held the stock long enough, the income he receives from the sale is treated as long term capital gain and taxed at a much lower rate.

Thus, the tax law encourages corporations to retain earnings rather than distribute them to shareholders. Faced with a pile of retained earnings and the need to invest them profitably, many corporations have turned to the acquisition of going businesses. The pressure to buy is compounded by the desire of shareholders to increase the net worth of the corporation through acquisition so that they may enjoy the advantages of capital gains over ordinary income.

One solution to this problem would be to provide that in the event of a merger, the portion of gain represented by the increase in book value resulting from the acquisition be taxed to the shareholder as ordinary income instead of capital gain. Under this proposal, purchasing-company stockholders would pay ordinary income taxes at the end of their tax year on the portion of the increase in the book value of their stock which can be attributed to the purchase of the subsidiary.

I recognize that there are problems associated with reaching a fair valuation of the net effect of the merger on the book value of the acquiring company's stock. However, these are accounting questions of the type that are handled routinely in corporate financial administration. Questions will arise as to the proper tax treatment if the acquisition reduces book value, as in cases where the acquired company has a negative book value. In such cases, fairness may well require recognizing losses as well as gains for stockholders.

I believe such problems can be worked out and would provide a workable way to diminish the present bias toward concentration that now exists in the tax code.

Chairman **STARK**. Thank you very much for your testimony, John. I hope that we can call upon your expertise periodically during this complicated situation.

Mr. **SEIBERLING**. Thank you. I am not as expert in tax laws as I am in antitrust laws, but I will be glad to supply whatever advice I can.

Chairman **STARK**. Thank you.

Mr. Heftel.

Mr. **HEFTEL**. Thank you for your participation, John. I wonder if you have focused on the way that interest rates are determined in the marketplace for such acquisition activities.

We apparently have a situation in which the lowest interest rates are those charged for this type of corporate activity. We don't know whether they are paying prime or not, but it is reasonable to assume, because of the security involved, that it is less than prime.

As a result these kinds of activities may be financed at low interest rates, while the interest rates charged to businesses that borrow money to expand or increase their productivity are highly leveraged against them.

You may find that a middle-sized business is paying 19 or 20 percent plus points whereas a takeover is being accomplished perhaps at 13 or 14 percent, because if they can't get a desired interest rate they can go into the money markets.

I wondered if you have focused on the way banks describe prime, the way prime is described to the public and whether there is an inherent problem?

Mr. **Seiberling**. I have been aware of that problem. As a matter of fact, the bigger the acquiring corporation—and some of them are very big indeed—of course the lower their interest rates are because the lenders feel that the risk is very low.

As a matter of fact, the risk is low in most of these acquisitions because all of the facts are known in advance, whereas to expand or build a new business is a higher risk, so the bankers take that into account.

But there is another aspect to this, too. As we have seen in recent months, many of these huge corporations—Mobil is an example—started out by not even borrowing the money but by getting commitments from the bank that they would have a line of credit available and then the companies who were fighting takeovers themselves lined up huge lines of credit.

So here we have billions of dollars of capital tied up at very little interest rate, practically zero interest rate.

Mr. **Heftel**. Maybe as little as a half a percent?

Mr. **Seiberling**. Yes, half a percent, and yet that capital is committed and therefore not available for other borrowers, so these must have a tremendous effect on the tightening of capital, and therefore the escalation of interest rates generally, as well as the advantages given to the acquiring corporations of lower interest rates.

So that does need to be looked into. I guess it is a different committee that deals with that, but certainly your committee could make some strong recommendations along those lines.

Mr. **Heftel**. Thank you very much.

Thank you, Mr. Chairman.

Chairman **Stark**. Thank you very much, John.

Our next witness, the Honorable Berkley Bedell, Member of Congress from Iowa, also a small businessperson himself and a distinguished member of that committee, who I am sure will have some interesting testimony for us.

We have your complete statement. Without objection, it will appear in the record, and you may proceed in any manner you wish.

STATEMENT OF HON. BERKLEY BEDELL, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF IOWA

Mr. **Bedell**. Thank you, Mr. Chairman.

I would first of all like to commend you and the members of your subcommittee for holding this hearing to examine the relationship between merger activity and the Internal Revenue Code.

I may say that I agree very much with the testimony of my previous colleagues, and you will find my text tracks quite closely to that of Senator Metzenbaum, in regard to his specific concerns.

For too long now, we have tended to look at these two items in isolation from each other: merger activity and the Internal Revenue Code. Yet, our tax laws clealy do affect the behavior of corporations in this regard.

In the 96th Congress, I chaired the House Small Business Subcommittee on Antitrust. We held extensive hearings on the subject of conglomerate mergers and their effects on small business and local communities. We found that these couplings of giant corporations, one to another, frequently do have severe adverse consequences for the communities involved and for the small businesses that are affected.

If you would like, I can go into greater detail concerning our conclusions about the consequences of conglomerate mergers. However, I believe this subcommittee will be even more interested in another of our findings.

We looked at half a dozen different mergers and had our staff examine many more. We found that tax considerations played a major role in most of the big mergers we studied. In fact, in many instances, the merger activity appeared to make little or no economic sense, except when viewed through the filter of the tax code.

Mr. Chairman, I no longer chair the Antitrust Subcommittee, although I continue to serve on it. I have continued to follow the news accounts of more recent mergers. In looking at some of the most notable mergers of the past several years, it continues to be evident that the tax laws have had a substantial influence in shaping the course of events. Personally, I find this very disturbing.

As you know, I come from a business background, and I have great sympathy for those who complain about the distortions in our economy that are caused by undue Government interference with the marketplace. For that reason, I am here today to urge you to correct those portions of the Internal Revenue Code which have distorted business economics to such an extent that those who engage in merger-related activities are today given artificial economic rewards.

As the chairman knows, I have been working for some time now on legislation that would correct these defects in the tax code. Regrettably, your hearing today comes before my bill is ready for introduction. I am prepared, though, to discuss with you the broad outlines of what I think needs to be done and to share with you an outline of my legislative proposal.

I have an attachment to my testimony, Mr. Chairman, which deals with the major outlines of what I am proposing.

Chairman **Stark**. Without objection, Mr. Bedell, that will be made part of the record.

[The attachment follows:]

Summary of Key Provisions of H.R. 6604

(Introduced by Mr. Bedell et al.)

Sec. 1. Title: "The Truth in Merger Economics Act."

Sec. 2. Limitation on the Filing of Consolidated Returns; Amendment to Sec. 1501 of the Internal Revenue Code of 1954.

Any corporation that has been a member of an affiliated group for less than 36 months must file a tax return that is separate from those corporations affiliated with the group for more than 36 months who choose to file jointly.

Transactions between an affiliated group filing jointly and affiliated members filing separately would appear on their respective tax returns.

SEC. 3. Liquidations Treated as Sales; Amendments to Sections 336 and 337 of the IRC.

When a large corporation (defined as one whose outstanding stock has a fair market value that exceeds $100 million) participates in a complete or partial liquidation of property, as being in control of either the liquidator or receiver, a gain or loss on the transaction must be recognized by the distributing corporation upon the distribution of the property.

Control is determined as having ownership of stock possessing at least 80 percent of the voting power of all classes of voting stock.

This provision would not apply when the basis of the property remains the same to the receiving corporation as it would have been in the hands of the transferor.

SEC. 4. Increase in the Holding Period of Stock for Distribution of Appreciated Property in Redemption of Stock. Amendment to Sec. 311(d)(2) of the IRC; repeal Sec. 311(d)(2)(B).

If a corporation distributes property to a shareholder in return for all of his stock in the corporation, and the fair market value of the property exceeds its adjusted basis, then a gain must be recognized by the distributing corporation unless the shareholder has held at least 10 percent of the corporation's outstanding stock for the preceeding 48 months. (Current law states the shareholder need only hold the stock for a 12 month period.)

Effective dates of all sections upon enactment.

Mr. BEDELL. Thank you.

When the legislation is ready for introduction, I will send copies of it to you. Actually, the short title of my proposal sums it up pretty well. It is "The Truth in Merger Economics Act."

All that it would do is remove from the Tax Code those elements that form artificial and harmful stimuli to merger activity. If these problems in the Internal Revenue Code are corrected, then I believe we will see a moderation in Corporate Merger Act behavior, and less harm to our economy from giant mergers that are tax induced.

Briefly, there are three main elements to my proposal. I believe they track very closely some ideas already under consideration within this subcommittee, but there are some subtle differences, and I want to discuss them with you.

First, there is the matter of filing consolidated tax returns. Today, it is entirely too easy to transfer tax credits or liabilities from one firm to another. A company that owes millions of dollars to the Government can be suddenly relieved of that obligation simply because it acquires another firm or is itself acquired. We have seen tax-sheltering become an important consideration in merger activity.

The problem extends beyond the merger itself, of course. Once the tax-sheltering occurs, by virtue of the consolidated return, a company may acquire an unfair advantage over its competitors who must continue to pay taxes. Thus, we see a form of Gresham's Law, the tax-sheltered company is now able to use that artificial advantage to drive out other healthy firms.

My suggestion is to require that companies that merge must continue to file separate tax returns for 3 years after the merger. This would assure that the short-term tax considerations are not the chief factor in the merger.

Second, there is the matter of liquidation of assets. I believe that when assets are acquired through merger and are then transferred, the transaction should be treated as a sale for tax purposes. However, I would apply this concept only in cases involving large corporations.

Most mergers involving large companies occur in the form of tax-free stock swaps. What often happens next is that fully depreciated or otherwise undervalued assets are transferred from the acquired company to the prevailing firm. At that point, the tax writeoffs start all over again, only at the new and higher value of the property.

It is my feeling that such liquidation should be allowed only if they are treated as sales, with gains or losses being reported on unconsolidated returns and taxes being paid accordingly. Otherwise, we will continue to see spectacular examples of tax avoidance through this device.

Where my proposal differs from what you are considering, Mr. Chairman, I am told, is that I do not believe it is necessary to extend this principle to smaller firms, as they are less likely to be engaged in the tax-free stock swapping. In the case of the smaller firms, the transaction is more likely to be on a cash basis and the tax consequences would have already been factored in.

Third, and finally, there is the matter of the holding period of stocks for distribution of appreciated property in redemption of stock. The current law states that if a stockholder has held at least 10 percent of a firm's stock for 12 months, then he can trade that stock for appreciated assets of the company without the seller incurring any capital gains tax liability. I believe the holding period should be increased to 48 months.

Again, what we have in the current law is an invitation to tax avoidance. One year is too short a holding a period to deter cash-rich companies from using this method of escaping taxation on certain transactions. A 4-year period, on the other hand, would probably be sufficient to discourage speculative ventures of this nature.

I suggest retaining some form of the holding period concept, because we have seen that it is needed by smaller firms in some instances. The two most obvious examples are the dissolution of closely held corporations and the transfer of ownership to employee groups.

In those cases, the longer holding periods should not be a problem. I think Senator Metzenbaum very clearly outlined some of the problems caused by this particular segment of our tax laws.

Mr. Chairman, again I want to express my thanks to you for holding this hearing and to encourage you and your committee to act expeditiously in this area. If there is anything I can do to be of further assistance to you, you can be assured that I will do whatever I can.

Chairman STARK. Thank you very much, Berke.

Mr. Heftel?

Mr. HEFTEL. I thank you for your interest and concern. I have no specific questions. Thank you.

Chairman STARK. I think, Byron, you introduced the first bill of this type, and it spurred a lot of us to more activity. With that I want to welcome you to the committee.

If you have a prepared statement, it will appear in its entirety in the record and you may proceed in any manner you desire.

STATEMENT OF HON. BYRON L. DORGAN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NORTH DAKOTA

Mr. DORGAN. Thank you very much, Mr. Chairman.

I appreciate the opportunity to testify today on this legislation. I never quite know whether to appreciate parentage ascriptions in this Congress, but I am interested in this subject.

I did last year introduce a bill called the First Things First Credit Act.

A number of bills followed that and I especially appreciate your willingness to hold hearings on them. I think it is a very important issue for this Congress to address.

My interest in this subject stems at least in part from my feeling that the Henry Fords and the Thomas Edisons of America have given way to a new group of finance wizards who generate profit without creating wealth, and that is one of the difficulties of the American economy today.

There are five bills under discussion. Most of the bills deal with the question of corporate mergers, and acquisitions—how they are financed and what kind of consequences they have for this country.

There is an avalanche of mergers and acquisitions in this country. About $82 billion worth of mergers and takeovers occurred last year. That is double the previous year.

This $82 billion was about 25 percent of all business investment last year, and just think of what that $82 billion could have done had it been put to more productive use.

It is my feeling that these mergers and acquisitions are hogging this Nation's credit.

Nobody knows precisely how much, but the Consumer Federation of America looked at the 33 largest mergers, and this extrapolated that about $34 billion in credit is going to.

This credit hogging drives up interest rates for everybody else in this country that needs credit. The Government isn't the only institution that is in the credit market driving up interest rates. The private sector is doing it too, with mergers and acquisitons that in my judgment are unproductive and that are pushing up interest rates.

I am not suggesting that the Government necessarily is doing right or that the private sector is doing wrong. I am saying that both groups, the public sector represented by the Federal debt, and the increased use of credit in the private sector for mergers, and acquisitions, both exert a tremendous influence on the interest rates in this country, and I think that that is detrimental.

These corporate acquisitions that we see taking place are not necessarily a result of the free market.

The fact is, Government subsidizes these acquisitions in part, and that has been my concern.

The Federal income tax deduction for credit alone means that the taxpayers conceivably would chip in 46 cents of every $1 in interest that the corporations pay when they borrow money to finance these mergers.

Other provisions play a part as well in mergers and acquisitions. Tax provisions, as you know, in many cases, turn good investments into bad investments and turn bad investments into good investments, United States Steel, for example, stands to gain, according to some publications, at least $1 billion in tax breaks by its purchase of Marathon Oil Co.

That is at least in part a loophole induced acquisition. It is not the free market.

These acquisitions in my opinion are a completely unproductive use of credit. We don't have new jobs except for the lawyers and accountants and financiers.

There is no new wealth. There is just expensive new legal clothing for existing wealth, and that seems to me to be the issue.

These takeover battles are diverting management time and energy away from the more productive endeavors they ought to be involved in. Instead of doing what Henry Ford used to do in the early days, trying to figure out how you can build a good, sound product and sell it to the American people who need it, and make a profit, what we have now are executives of American corporations plotting takeover strategies, and it seems to me that we ought to take a look at the Japanese in this regard.

Japanese law discourages corporate takeover battles. They rarely occur, and one reason I think is that the Japanese understand their interest is to spend their management time, their entrepreneur time in developing and producing better products. It is what their executives think about and more and more it is what our executives ought to be thinking about, not acquisitions, not takeovers, but how do they build a better toaster, a better tire, a better television set to sell to the American people.

Mergers and acquisitions smother the genuine innovators risk-takers and producers in conglomerate bureaucracies and red tape.

Business Week magazine quoted someone who had been taken over by one of the major oil companies. He said, "It is a full-time job just filling out all the forms that Exxon wants."

This was an executive of a small company that had been purchased by Exxon.

Thomas Jefferson thought that independent farms and business—the widespread dispersal of wealth—were essential to a political democrary and I tend to agree.

I don't think big is always bad and I don't think small is always beautiful, but I do think that when we create tax laws that induce acquisitions and mergers for artificial purposes, we detract from the productive efforts of this country, and that does a real disservice to the economic health of America.

Locally owned businesses I think are the economic basis of a community. The administration continues to talk about community and then it acts as a cheerleader for the mergers and acquisitions that often destroy this economic base.

I have felt for a good long while the fellow in the Justice Department who is in charge of the antitrust policies of this administration ought to be relieved of his job quickly.

He is not packing very quickly, but the fact is, I don't think he is doing a very good job over there, in fighting antitrust activity.

I would like to mention in closing that H.R. 4562, the First Things First Credit Act that I have introduced, applies only to contested takeovers.

It seems to me now that this bill could well apply to all mergers and acquisitions. I certainly wouldn't oppose that. The issue these days is how do we effectively use a scarce supply of a very important resource; that is, credit.

We have only a certain amount of credit available in this country today. How do we effectively use that in the private sector to get this economic engine of ours moving and making some progress once again?

Well, I think we do it in a number of different ways, one of which is to try and make sure the available credit is directed to that part of the economy that will use it to build things, to create wealth, to produce new jobs. That kind of investment is what gets this country's economy back on track; not takeovers artificially induced by the tax laws.

I would like to encourage your committee to move from hearings to active consideration to get a bill to the floor of the House that would do something similar to what I have suggested in H.R. 4562.

I think if we get American entrepreneurs back to being entrepreneurial, and get American corporate mangers back to managing—to figuring out how to get a good product on the shelf that the American people want to buy at a profit to the producer—then I think we will have accomplished something.

As I said at the outset, we are turning the old Henry Fords and Thomas Edisons of America into a new type of financial wizards who are generating profits in the short run but not creating wealth for this country, and that is one of the economic problems that I think this type of legislation can help correct.

Again, let me compliment you, Mr. Chairman, and the committee, on being willing to hold hearings on controversial topics such as this.

[The prepared statement follows:]

STATEMENT OF HON. BYRON L. DORGAN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NORTH DAKOTA

"When top-drawer borrowers, such as DuPont, Seagram, and Mobil, hit the banks for multibillion dollar loans to finance merger bids, there is less left for small business, would-be homeowners, or other borrowers."—Business Week editorial, August 3, 1981

"Takeovers by the corporate giants have weakened or destroyed countless thousands of small and medium-sized businesses that were star performers when they were independent."—Arthur Burck, securities lawyer and merger specialist, in interview in Fortune magazine, October 19, 1981

Imagine another shortage. People are sitting for hours in sweltering gas lines that stretch on for blocks. At the same time, an enormous fleet of Mac Trucks is parked in a lot, their engines racing. The trucks never go anywhere. They never carry any freight. They just keep trading parking spaces with one another, racing their engines and burning gas.

Imagine further that the federal government helps to buy the gasoline for this fleet of go-nowhere trucks.

That is almost precisely what is happening with this nation's scarce supply of credit.

Credit is the gas on which our economy runs. It is in short supply. The price is so hight that may business people and farmers cannot afford it. Bankruptcies are at record levels. The entire economy is sputtering.

CREDIT GUZZLERS

Yet many of our larger corporations are guzzling billions of dollars of our scarce credit for purposes that are about as useful as the Mac Trucks gunning their engines in the parking lot.

They are not using these loans to build new factories or to buy new machines. They are not creating new jobs. except for the lawyers and accountants who grow rich orchestrating megadollar paper shuffles. Instead, they are draining the nation's credit supply merely to buy and sell one another—to trade places in the economic parking lot.

Corporations spent over $82 billion last year playing this monopoly game. That was more than double the amount so spent the year before. If that $82 billion had gone into new factories and equipment instead of into buying up other companies, we could have increased business investment by 25 percent last year.

The $82 billion that corporations spent buying up one another last year was many times the amount they will receive in tax cuts next year. We could have provided a much greater spur to new investment, at virtually no cost to the U.S. Treasury, if, instead of those new tax giveaways, we had simply channeled some of the $80 billion in more productive directions.

A substantial portion of these takeovers was financed with borrowed money. Nobody knows exactly how much. After examining the financing for the 33 largest deals, the Consumer Federation of America estimated that approximately $34 billion in credit was used for all such takeovers last year.

TAKEOVER TOLL

And that's just the beginning. When you count the credit commitments made to companies that tried to take over other companies, and the commitment made to target companies to help them fight off such attempts, the CFA estimates that a total of approximately $70 billion of the nation's credit supply was diverted into the corporate takeover wars.

How much credit is $70 billion dollars?

It's almost as much as the total value of everything American farmers grew last year. It was enough to finance all farm operating loans made by insured banks in all 50 states in 1980—two times over.

Look at it another way. The $5.5 billion line of credit that Mobil used in its effort to buy up Conoco, was enough to finance all the business and farm operating loans in my state of North Dakota that year, three times over.

This Administration's Dr. Spock-like permissiveness regarding big corporations and their merger plans, no doubt is partly responsible for this torrential credit drain. But we in Congress must share the blame. A number of provisions in the federal income tax laws—for which we are responsible—actually encourage and subsidize the waste.

STUDENT LOANS FOR CORPORATIONS

For example, when a corporation like Mobil borrows money to buy another company, it can deduct the resulting interest payments from its Federal income taxes. In effect, the U.S. Treasury chips in about 46¢ for every dollar in interest such corporations pay.

It's like a subsidized student loan program—for corporate mergers. And while we cut the student loan program, the merger subsidy program keeps growing bigger.

It's also doing us great harm.

The guzzling of credit for corporate mergers and takeovers means less for everyone else—and higher interest rates.

SNOUTS AT THE TROUGH

There's been a lot of talk about how the Federal Government's appetite for credit is "crowding out" other borrowers. There's truth in that. But the Federal Government isn't the only big snout at the nation's credit supply trough. This wasteful corporate borrowing is right in there too. As Business Week Magazine put it in an August 3, 1981 editorial, "When top-drawer borrowers, such as DuPont, Seagram, and Mobil, hit the banks for multibillion dollar loans to finance merger bids, there is less left for small business, would-be homeowners, or other borrowers."

In other words, the $70 billion in credit that went into the merger and takeover wars meant $70 billion less—and higher interest rates—for the Main Street businesses, the farmers, the builders, the individuals who want to buy homes and cars.

These higher interest rates in turn put many smaller businesses so deep in the hole, that they have to choose between selling out to a larger company, or going bankrupt. In this way the corporate merger spree becomes a syndrome that keeps feeding upon itself.

This isn't just a problem for smaller businesses, moreover. It is a monkey wrench in our entire economy.

Consider the billions of dollars Congress spent last year on new corporate tax cuts, that the administrations persists in calling an "economic recovery" program. We were told that those new tax breaks, that went primarily to the very largest corporations, would be used to invest and build and create jobs and prosperity. But that did't happen. Instead, much of those billions disappeared down the merger and takeover drain.

STEEL'S ROVING EYE

Consider the United States Steel Company. These companies have been blaming their troubles upon the Japanese, the Koreans, the federal government, on just about everyone. If there is one industry that needs new plant and equipment, it is steel. Yet when United States Steel accumulated a sizeable bank account, through new tax breaks and otherwise, did it build a new steel plant?

No. It went out and paid $6 billion for an oil company.

How can we ever have a healthy steel industry, if our steel industry itself loses interest in building a healthy steel industry, and if our federal income tax laws encougage our steel executives' roving eye?

What good does it do to give billions of dollars in new tax breaks to big corporations, supposedly for new investiments, when tax breaks already in place encourage these corporation to use this money instead simply to take legal title to old investments?

We are always talking about creating new loopholes—politely call "incentives"—when we ought to be talking about eliminating some of the loopholes that impede economic recovery.

It's not just the diversion of capital, moreover. Perhaps more important is the diversion of the time and energy of our corporate executives themselves.

Instead of spending their time designing and producing better products, they sit around plotting like pirates to take over other companies, or to defend their companies from such pirateering.

Just look at the top executives in our major corporations. Increasingly, they are people who don't know a thing about production processes or products. The Henry Fords and the Thomas Edisons have given way to the finance wizards who generate profit without creating wealth. Our economy is performing accordingly.

LESSON FROM JAPAN

On this point we can learn a lesson from the Japanese. In Japan, mergers and takeovers are rare. Japanese law makes them very difficult. Partly as a result, Japanese executives can spend their time developing and producing better products and selling them all over the world. They can use their nation's supply of credit in a similarly-productive fashion.

Each will draw his or her conclusion on whether the Japenese approach to mergers, or ours, is working better.

While corporate takeovers are diverting the attention and energies of our executives, they are engulfing the genuine producers in our economy in a sea of conglomerate paperwork and redtape.

Traditionally, opponents of such mergers have talked about the lessening of competition. That's important. But equally important is the loss of the initiative and vision of individual entrepreneurs that has always been the spark that has kept our economic engine moving.

When a giant corporation like Exxon buys up another company, especially a smaller one, people who were accustomed to making their own business decisions, taking their own risks, suddenly find themselves forced to push paper through endless channels and higher-ups just to make simple business decisions.

"FILLING OUT THE FORMS"

"It can take a year to get approval for a strategy change." The cofounder of one small company gobbled up by Exxon complained to Business Week magazine, "The speed at which Exxon moves is incredibly slow."

"It's a full time job just filling out all the forms Exxon wants," grumbled the founder of another small company that lost its independence to Exxon's empire-building appetite.

And an engineer for an independent oil company taken over by Tenneco moaned to a Wall Street Journal reporter, "It took me eight weeks to get management to approve a work order just to move a telephone inside my office."

This stifling conglomerate bureaucracy can be the kiss of death for the smaller, more enterprising busineeses so acquired. A recent study at the Massachusetts Institute of Technology found that small companies taken over by larger ones fail much more frequently than do those that remain independent.

"Takeovers by the corporate giants have weakened or destroyed countless thousands of small- and medium-sized businesses that were star performers when they were independent," Arthur Burck, nationally-known securities lawyer and merger specialist, told Fortune magazine last October.

If we wanted to crush the spirit of initiative and individual risk taking in America, and to cut off our free enterprise system at its roots, we could find no better way than to let the current corporate merger spree go unchecked.

JEFFERSON'S WORRY

The opportunity to be your own boss, and to achieve the financial independence that enables you to speak your mind in public affairs, is part of what America is all about. Jefferson held the view that business independence is essential to Democracy. He did not think Democracy could survive if economic power became concentrated in a few hands.

If Jefferson were with us today, I think he would be worried.

It isn't just a question of economic efficiency. It's doubtful that an economy dominated by a few large corporations can be very efficient even in an economists' sense. But even if it were, that wouldn't be the end of the matter. America stands for more than efficiency. It stands for opportunity, for community—for values that have made us a light of the entire world.

Community is not hyroponic. It does not grow in thin air. Community requires an economic culture of local business people who do their business with local banks and supplies, who know their customers and employees face to face. It requires business people with homes and children and a consequent personal stake in the community's well being.

Locally-owned businesses are a cohensive force that helps to bind together all the rest.

BAIL OUT

When locally-owned businesses are bought out by larger ones, all this changes. There are no more roots. Local banks and suppliers are shunted aside. The factory or supermarket or fast-food outlet becomes just a line item on a conglomerate balance sheet. If times get rough, they don't roll up their sleeves with their neighbors. More likely, they bail out.

The current Administration speaks admirably about "community." But then they become cheerleaders for the mergers and acquisitions which frequently destroy the economic basis of the very communities that they say they value so highly.

Some will disagree. They will offer sophisticated arguments on how corporate mergers advance "efficiency" and other abstractions from the economic texts. They will say, in effect, that the very fact that these mergers occur, makes them somehow right.

Obviously, not every corporate acquisition is to be regretted. Sometimes the owners of smaller businesses want to sell out and retire. Sometimes, acquisition by another company is the only alternative to collapse. But such mergers would happen anyway, without special provisions in the tax laws pushing in that direction.

The major mergers we have seen of late do not fit these categories of innocence. When United States Steel bought Marathon, it was not a case of the tired head of a family business selling out so that he could move to Florida. Nor was it a distress sale.

Rather, United States Steel had its eye on, among other things, the billion dollars in special tax breaks it stood to gain from this deal. That was, in large measure, a tax-loophole-induced merger.

LAWYERS' "BONANZA"

"Whatever new practice areas lawyers dream up," declared Fortune magazine recently, "it's doubtful that they will ever strike a bonanza as big as takeover work." Fees for this work, according to Fortune, run $400 to $600 per hour, or over three times what someone working for the minimum wage will make in an entire week. The two leading merger lawyers in New York City each take home over one million dollars per year.

When Mobil and United States Steel were battling to buy up Marathon oil, the lawyers who conducted this fracas made over $10 million. And when DuPont bought Conoco, the cut for the investment bankers was $29 million.

GOOD WORK IF YOU CAN GET IT

Corporate executives benefit as well. The management consulting firm of Towers, Perrin, Forster and Crosby found that chief executives at the 100 largest industrial firms make more than twice the compensation enjoyed by their counterparts at firms ranked 400 to 500. The bigger the company, the bigger the boss's paycheck, and this alone is an inducement to the boss to try to make the company bigger, fast.

We might as well face it. Corporate mergers and acquisitions have become a train of handsome gravy for the lawyers, accountants, executives and financiers who have a piece of this action. Many who oppose the legislation before us today, fall into this group.

I am not suggesting that those with an economic interest in mergers and takeovers have nothing of value to say on the subject. But big mergers do mean big dollars for those involved, and such people may not be inclined to look too critically upon the hand that feeds them so well.

It is my view that we should discourage mergers and acquisitions, so that the energy and resources of our business people can flow in more constructive directions, and so that the economic basis of our communities and of our democracy can flourish. At the very least, we should stop using the powers of government—specifically, the tax laws—to encourage and reward this form of behavior.

BACK TO FREE MARKET

I am not talking about interfering with the "free market." I'm talking about getting back to the free market—about eliminating the tax provisions that distort this market by encouraging corporations to do that which they might not do otherwise.

I am suggesting only that mergers and acquisitions stand on their own merits, and not on the back of the U.S. taxpayer.

The simplest place to start would be to eliminate the tax deduction for borrowings used in corporate takeovers and acquisitions. I have introduced a bill, H.R. 4562, the "First Things First Credit Act of 1981," to accomplish this.

As presently drafted, H.R. 4562 would apply only to takeovers that are fought by the company being acquired. To be sure, such contested takeovers can be the most monumental diversion of corporate energies and resources since the invention of the expense account. But, the ill effects of credit-financed mergers arise whether they are contested or not.

For this reason, I am now of the view that Congress should deny the interest deduction for all mergers and acquisitions when the combined assets of the companies involved exceeds a set amount, perhaps $200 million.

Beyond this, I support in principle your own bill, H.R. 6295, which would eliminate a number of loopholes which give companies involved in mergers and acquisitions special bonuses not available to those who mind their own business. I have not had an opportunity to review this bill in detail. But clearly it is the direction in which our federal tax policy should go.

I want to commend you, Mr. Chairman, for holding these hearings today. It's about time Congress started looking at the way the loopholes and complexities in our tax laws have twisted our entire economy out of shape. Loophole-induced mergers and takeovers are exhibit number one. To eliminate these tomorrow would not be too soon.

Chairman **Stark**. Thank you very much, Congressman Dorgan.

Again thank you for your leadership in this area. It has been an incentive for us and we appreciate your testimony.

I must add I couldn't in general agree with you more.

Mr. Heftel.

Mr. HEFTEL. Mr. Chairman, I certainly want to compliment you for your initiative in the whole area of mergers and takeovers.

I thought I would share with you some thoughts about the lesson from Japan. Japan has virtually no antitrust laws or restrictions. In fact in Japan the Government encourages mergers, a combination of what here would be competing companies. In fact the Japanese have, for example, one giant advertising conglomerate that will do the advertising for competing products all the way through the industrial spectrum.

Thus, it seems that the Japanese do not have antitrust restrictions; that the Japanese Government encourages the merging and joining together of competing firms; and that the Japanese Government participates in the allocation of credit, and puts industry and banks together in groups to make sure that credit is available. Would you care to comment on the lessons that Japan may provide to us?

Mr. DORGAN. The Japanese system is markedly different from ours. I think there is a much different kind of coordination and central planning between the public sector and the private sector in Japan.

Also, in the private consumption area the Japanese tell their citizens that if you want to buy a home, for example, you are going to have a significantly larger downpayment than in America, and in so doing, they provide a tremendous incentive for personal savings, which represents the investment pool for their private sector.

I would like to make one other point if I might, Mr. Chairman, in leaving.

I know that this legislation and the legislation you have introduced will be called antibusiness. Nothing could be farther from the truth.

In my opinion, for the Federal Government, through its tax laws, to subsidize the mergers and acquisitions which threaten the free market system, and the competition that is the bedrock of our economic system, is a disgrace. We ought to get those influences out of our tax systems, and to do so is not "antibusiness." It is pro competition and pro free enterprise.

If there is a reason for a merger or acquisition to take place, let it take place on its own merits, not because it is artificially subsidized by something in the tax code.

Chairman STARK. I quite agree. I guess if one could dream up a reason that a merger was in the best social economic interests of the country, we might be willing to subsidize it in the tax code. But those types of situations occur very infrequently.

Mr. Heftel.

Mr. HEFTEL. It would seem that the stepped-up basis provided where a merger is followed by a partial liquidation constitutes one of the greatest problems with the corporate tax system. We have provided a significant tax incentive for encouraging a merger, because with a few dollars changing hands, great numbers of tax dollars will be saved by writing off the stepped-up assets all over again. Therefore, I want to commend you again, Mr. Chairman, for calling attention to a significant tax problem that we have to focus on.

Thank you very much.

Chairman **Stark**. Thank you very, very much.

Our next witness is Hon. Cooper Evans from the State of Iowa.

Mr. Evans, welcome to the committee. If we have a prepared statement from you, it will, without objection, appear in the record in its entirety. You may proceed in any manner you see fit.

STATEMENT OF HON. COOPER EVANS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF IOWA

Mr. **Evans**. Thank you, Mr. Chairman and members of the committee.

I truly appreciate the opportunity to appear here today to discuss the growing problem of corporate mergers.

I again want to compliment the committee on taking up this subject, which I think all of your witnesses have agreed is of extreme importance at this point in time.

I would like to make it clear that I personally am not opposed to the idea of corporate mergers in general.

I personally think that some of these may be beneficial and desirable for the economy, but in times of economic hardship, I believe the Government needs the flexibility to regulate this type of activity when it impacts the credit markets to a great extent and ties up large blocks of capital that could otherwise be used to stimulate economic recovery and lower interest rates to both business and the consumer. This is my primary motivation for introducing the bill of mine that you have before you, H.R. 5517.

There has been considerable discussion today on the extent of merger activity in the country. It has been noted already, I think, that the total of corporate acquisitions in 1981 was something like $82 to $83 billion.

This amount covers some 2,395 transactions, but of this number 12 mergers were valued at more than $1 billion each. These 12 alone accounted for a total of $38.4 billion. In my judgment that is where the real problem is.

This included an $8 billion acquisition of Conoco by DuPont, the $4.3 billion purchase of Texasgulf by Société Nationale Elf Aquitaine, the $2.9 billion acquisition of St. Joe Minerals Corp. by Fluor Corp., and the $2 billion takeover of Kennecott by Standard Oil of Ohio.

A point of interest is, I think, that although the Conoco acquisition ultimately cost $8 billion, during the lengthy acquisition process more than $28 billion in credit was tied up for this purpose, and that at a time when this capital was badly needed by the economy for other purposes.

A recent CRS report states that "in the current wave of merger and takeover activity, a significantly greater proportion of the deals are for cash, whereby stock is purchased by the bidder on a tender offer basis."

Market conditions are a primary reason for the large number of recent mergers. High inflation and high interest rates have depreciated the value of corporate assets and have increased the reluctance to risk new ventures.

Mergers have thus become safer and cheaper alternatives for these corporations than modernizing or expanding their existing plants and equipment.

To finance these mergers, corporations are borrowing billions of dollars at high interest rates. This type of borrowing is largely unproductive since borrowing for a merger creates nothing new. A corporation simply buys another existing operation.

Billions of dollars of borrowed money are invested for something that neither creates new jobs nor increases productivity.

In fact, mergers actually increase the competition for the limited amount of money available in the lending markets and tend to keep all interest rates high.

The goal of our economic program is to lower interest rates and to provide capital for plant expansion and to create more job opportunities. Borrowing to finance mergers and acquisitions runs counter to this program and its goals.

The tax policy of the Federal Government certainly contributes to the problem. Interest paid on funds borrowed to finance mergers is deductible from income taxes. This means that there is just as much incentive for a large corporation to borrow for a merger as there is to borrow funds for plant expansion or modernization.

United States Steel, for example, could be borrowing to refurbish its plants and to increase its productivity. Other corporations could be borrowing for the purchase of new equipment and expansion to create new jobs. Mergers yield none of these benefits, but instead they contribute to the continuation of high interest rates that are causing so many problems today for consumers, farmers, and small businessmen.

I believe that we need to change our Federal tax policy to stop encouraging and subsidizing the mergers of giant corporations, particularly in periods of tight money. We need to create more jobs and more efficient and productive industry, not more conglomerates.

Toward this end, I introduced H.R. 5517. It takes a somewhat different approach from other bills you are considering.

It would allow the President to declare a moratorium, for a period of not longer than 2 years, on the tax deductibility of interest on loans made during that moratorium to finance corporate mergers and acquisitions.

This moratorium could be lifted at any time during the 2 years if the President determined that it was no longer required.

During and after the moratorium period, corporations would not be able to deduct interest payments on indebtedness incurred during the moratorium to acquire other corporate stock or assets.

While this would not prevent mergers, it would temporarily eliminate one important feature of our tax law which serves to encourage this activity.

I believe that it is best to give the flexibility to the President to determine when this moratorium should go into effect because I feel that this course of action should be used only in times of economic emergency, such as we are facing today.

Another feature of my bill, which I believe distinguishes it from the other proposals you are considering, is that the denial of interest deductions only applies when inerest payments exceed $5 million a year.

I have adopted this $5 million of deduction as a means of differentiating large mergers which tie up large blocks of capital from those acquisitions involving smaller companies which don't have as significant an impact on the credit market.

In summary, H.R. 5517 is, I believe, a simple and practical approach to dealing with large corporate mergers. My bill adds one new subsection to existing Tax Code provisions which treat corporate mergers and acquisitions.

It establishes a procedure for the President to intervene when the economic situation warrants it, to discourage the tying up of large blocks of credit for mergers and acquisitions.

It also defines corporate acquisition indebtedness, for the purposes of this subsection only, as "any obligation evidenced by a bond, debenture, note or certificate, or other evidence of indebtedness issued during this moratorium period, if this obligation is issued to provide consideration for the acquisition of stock or other assets of another corporation."

The remaining provisions of section 279 are left untouched. My bill would apply to only those obligations that are issued after the date of enactment of this legislation.

Mr. Chairman, I appreciate the opportunity to present my testimony and again I commend you and the subcommittee for addressing these very important subjects.

If you have any questions or I can be helpful in any way, I will be very pleased to answer or to do so.

Thank you very much.

[The prepared statement follows:]

STATEMENT OF HON. COOPER EVANS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF IOWA

Mr. Chairman, Members of the Committee, thank you for the opportunity to appear here today to discuss the growing problem of corporate mergers and acquisitions and specifically, my bill, H.R. 5517. I am not opposed to the idea of corporate mergers in general. Many of these may be beneficial and desirable for the economy. In times of economic hardship, though, I believe the government needs the flexibility to regulate this type of activity when it impacts the credit markets to a great extent and ties up large blocks of capital that could otherwise be used to stimulate economic recovery and lower interest rates to both business and the consumer. This is my primary motivation for introducing H.R. 5517.

A number of recent large corporate mergers and acquisitions have focused public attention on this issue. According to a recent study by the Congressional Research Service, in 1982 the total dollar value paid for corporate acquisitions was $82.6 billion. This amount covers 2,395 transactions, but of this number, 12 mergers were valued at more than $1 billion each. These 12 alone accounted for $38.4 billion. This included an $8 billion acquisition of Conoco by DuPont, the $4.3 billion purchase of Texasgulf by Societe National Elf Aquitaine of France, the $2.7 billion acquisition of St. Joe Minerals Corporation by Fluor Corporation, and the $2 billion takeover of Kennecott by Standard Oil of Ohio. Although the Conoco acquisition ultimately cost $6 billion, during the lengthy acquisition process, more than $28 billion in credit was tied up for this purpose, at a time when this capital was badly needed by the economy for other purposes.

CRS further reports that "in the current wave of merger and takeover activity, a significantly greater proportion of the deals are for cash, whereby stock is purchased by the bidder on a tender offer basis."

Market conditions are a primary reason for the large number of recent mergers. High inflation and high interest rates have depreciated the value of corporate assets and have increased the reluctance to risk new ventures. Mergers have thus become safer and cheaper alternative for these corporations than modernizing or expanding their existing plants and equipment.

To finance these mergers, corporations are borrowing billions of dollars at high interest rates. This type of borrowing is largely unproductive since borrowing for a merger creates nothing new. A corporation simply buys another existing operation. Billions of dollars of borrowed money are invested for something that neither creates new jobs nor increases productivity. In fact, mergers actually increase the competition for the limited amount of money available in the lending markets and tend to keep all interest rates high.

The goal of our economic program is to lower interest rates and to provide capital for plant expansion and to create more job opportunities. Borrowing to finance mergers and acquisitions runs counter to this program and its goals.

The tax policy of the Federal goverment also contributes to the problem. Interest paid on funds borrowed to finance mergers is deductible from income taxes. This means that there is just as much incentive for a large corporation to borrow for a merger as there is to borrow funds for plant expansion or modernization.

United States Steel, for example, could be borrowing to refurbish its plants and to increase its productivity. Other corporations could be borrowing for the purchase of new equipment and expansion to create new jobs. Mergers yield none of these benefits, but instead they contribute to the continuation of high interest rates that are causing so many problems today for consumers, farmers, and small businessmen.

I believe that we need to change our Federal tax policy to stop encouraging and subsidizing the mergers of giant corporations. We need to create more jobs and more efficient and productive industry, not more conglomerates. Toward this end, I introduced H.R. 5517 which decreases the tax incentives for borrowing funds to finance corporate mergers and acquisitions. I will briefly summarize how my bill would achieve this.

H.R. 5517 would allow the President to declare a moratorium, for a period of not longer than two years, on the tax deductibility of interest on loans made to finance corporate mergers and acquisitions. This moratorium could be lifted at any time during the two years if the President determined that it was no longer required. During the moratorium period, corporations would not be able to deduct interest payments on indebtedness incurred to acquire other corporate stock or assets. While this would not prevent mergers, it would eliminate one important feature of our tax law which serves to encourage this activity.

I believe that it is best to give the flexibility to the President to determine when this moratorium should go into effect because I feel that this course of action should be used only in times of economic emergency, such as we are facing today. The President would be in a position to respond more quickly than the Congress and would be more inclined to invoke these emergency powers than Congress would be to make permanent changes in the tax code.

Another feature of my bill, which I believe distinguishes it from the other proposals you are considering is that the denial of interest deductions only applies when interest payments exceed $5 million. Section 279 of the Internal Review Code provides that a deduction of up to $5 million per year on interest costs is allowed with respect to obligations issued for specified acquisition purposes, where these obligations meet certain tests specified within Section 279. I have adopted this $5 million deduction as a means of differentiating large mergers which tie up large blocks of credit, from those mergers and acquisitions involving smaller companies which don't have as significant an impact on the credit market. It is my intent to have these provisions apply only to those transactions which most adversely affect credit. I don't want to deny the option of a merger of acquisition in instances where it may be both necessary and desirable to keep a company in business.

In summary, H.R. 5517 is, I believe, a simple and practical approach to dealing with large corporate mergers. My bill adds a new subsection to existing tax code provisions which treat corporate mergers and acquisitions. It establishes a procedure for the President to intervene when the economic situation warrants it, to discourage the tying up of large blocks of credit for mergers and acquisitions. It also defines corporate acquisition indebtedness, for the purpose of this subsection only, as "any obligation evidenced by a bond, debenture, note, or certificate or other evidence of indebtedness issued during this moratorium period, if this obligation is issued to provide consideration for the acquisition of stock or other assets of another corporation." The remaining provisions of Section 279 are left untouched. My bill would apply to only those obligations that are issued after the date of enactment of this legislation.

Mr. Chairman, this concludes my prepared statement. I appreciate the opportunity to present my testimony and I commend you and the subcommittee for addressing the issue of mergers and acquisitions. If you have any questions, I would be happy to answer them. Thank you.

Chairman STARK. Mr. Evans, thank you very much.

One note: By the end of this morning, we will have heard from four members of the Iowa delegation on this topic. I guess if I were going to organize a new enterprise based on the interest of their congressional delegation, Iowa would rank pretty near the top.

Mr. EVANS. I think two of the bills come from Iowa, as a matter of fact. I don't know how we account for that, but we are very pleased to be here and participate in the hearings.

Chairman STARK. Your constituents are fortunate to have you here. I want to note the arrival of our ranking minority member, John Duncan, and ranking majority member, Mr. Holland. John do you have any comments or questions?

Mr. DUNCAN. I apologize for the delay. This was the earliest I could get here.

I do want to thank our colleagues. I know that they will be quite helpful and I shall read all your statements.

Thank you.

Chairman STARK. Mr. Holland.

Mr. HOLLAND. Thank you, Mr. Chairman. I apologize to the chairman and the members of the subcommittee and to the witnesses and interested parties for being late.

The reason I was late was because of an airline that probably is now going around trying to sell its tax losses instead of trying to serve its passengers.

I thank my colleagues for their testimony and I assure you I will read it over, and hope we can get some motion in this area in our tax code.

Chairman STARK. Mr. Heftel.

Mr. HEFTEL. I just want to thank you for your participation and thoughtfulness.

Thank you, Mr. Chairman.

Mr. EVANS. I would just say to Mr. Holland that it is better to be delayed by an airline that is having that kind of troubles than to be delayed by the one that I was on the other night when one of the engines quit.

Mr. HOLLAND. They are probably related.

Chairman STARK. Our next witness, Hon. Tom Harkin, a member of Congress from Iowa.

Tom, your prepared statement will be made part of the record. Without objection you may proceed in any manner you choose. Welcome to the committee.

STATEMENT OF HON. TOM HARKIN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF IOWA

Mr. HARKIN. Thank you, Mr. Chairman.

As you can see, we, in Iowa, have some concern over mergers and acquisitions.

I think it has something to do with the fact that in Iowa, we have a lot of small business. It is really a small business State, a big agricultural State. There has been a feeling for a long time in Iowa, going, I guess, clear back to the old populist movement in the late 1800's that farmers were being railroaded, first, by the railroads, and second, by the giant trusts and combinations, and there is a widespread feeling in Iowa today among our farmers, who are small businesses, and the small main street businesses, that much of the credit sources in this country are being used for these mergers and acquisitions which, No. 1, impact heavily on their ability they feel to get reasonable interest rates and to get the kind of money they need for their own operations, and, second, which in fact destroy their ability to enter the marketplace and to compete effectively in the marketplace, and so I don't think it is really all that strange that those of us from Iowa are very interested in this.

I will just make a couple of comments from my statement. Quite frankly, last year, when President Reagan proposed the huge tax breaks to big business and this Congress approved it, it was with the belief and understanding that in order to get our economy moving again, companies would need large amounts of capital for new investments.

They argued it would stimulate the economy, provide new jobs, and so forth. Yet we are still anticipating. We are still waiting for this to happen. Instead, a number of corporate giants have spent a great deal of time, energy, and money in the pursuit of other companies.

The history of the growth of this country reflects what Americans are most proud of, American ingenuity, and right now what is happening is rather than using the new economic benefits that they have, many of these large companies are going into hostile mergers, takeovers of other companies, rather than using their newfound economic wealth to invest in new plant and equipment.

I think the Congress ought to do what it can to reduce the number of mergers. I think there are basically three questions that I hope this committee will look at.

First, what specific tax provisions in the code actually promote mergers, and can they be repealed or changed to reduce that unintended impact?

Second, should the tax code contain specific provisions to dissuade mergers?

And third, should the companies be changed to reduce the negative effects on interest rates and the ability to borrow caused by large sums being used for hostile takeovers?

On the first point, I believe that every effort should be made to remove tax provisions which provide benefits that promote large mergers.

This issue is squarely met by the chairman's bill, H.R. 6295. The bill does address some very complex areas of the tax code and eliminates provisions which have provided incentives to acquire companies simply for the tax benefit.

The only caution I would raise, and I am certain that you raise it in your own minds every time you meet on the Ways and Means Committee, is that there is no doubt there are going to be some attorneys searching for ways and means to get around these provisions established by the bill.

It is going to be very difficult to change the present reality that many ongoing firms are worth more captured than they are free, so I believe you are on the right track with this bill.

I would just raise that one point about looking ahead to see what kind of end runs will be done on it.

The second question: Should the code be used to restrain mergers? In the case of large mergers, I believe it should. For decades, we have had antitrust laws which have been designed to block mergers or acquisitions which would restrain trade and substantially reduce competition.

I believe that antitrust laws have been useful. However, we must admit that they are not always effective. In addition, as noted above, there are more problems with large mergers than restraint of trade. I think that not only should we hand out a carrot, but we also should hold a stick out, too, on large mergers.

I don't believe that a merger provision should be so strong that it retards all mergers. Sometimes mergers can be useful.

The bill that I introduced, H.R. 5719, simply creates a 15-percent excise tax on large mergers or acquisitions. It covers those mergers or acquisitions where a company with more than $2 billion in sales acquires a company with more than $300 million in sales.

The 15-percent tax is based on actual sale price. Perhaps with a reduction on the promerger benefits which are in the code as contemplated in the chairman's bill, that figure could be lowered and have the same intended effect.

My bill does exempt two categories of mergers. First, where the acquired entity is losing a substantial portion of its equity.

The bill also exempts an acquisition from the tax if the acquisition would significantly improve a firm's ability to compete with some foreign competition. That decision, of course, being made by the Secretary of the Treasury and the Secretary of Commerce.

Additionally, the bill provides for a 50-percent excise tax when an American firm with sales of over $300 million is acquired by an entity controlled by a foreign government. Americans buy firms overseas and foreigners buy firms in the United States all the time.

However, they are all united in the profit motive. When a foreign government acquires an interest in a concern in the United States, they do bring other interests besides a profit motive. I believe that we should discourage such ownership of America's industrial base and a high excise tax on that type of transaction would help to avoid the problem.

There are those who would argue that the tax code should be neutral on the question of mergers, that it should be left to the free market.

I would say that the tax code is not neutral now and never has been and never really will be neutral.

It simply favors mergers in ways that are hidden and complex. We need to reverse that policy.

In addition to the structural benefits that our economy would enjoy from a reduction of merger activity, we would also see an increase in revenues which would reduce the government's deficit.

An excise tax would generate substantial revenues. The provisions of H.R. 6295 close loopholes through which more billions are lost in tax deductions.

It is common for the price paid for a company to exceed the market value of its stock by 50 percent.

That bonus price is, to a large extent, paid out of the U.S. Treasury.

The third area that should be examined is the effect of mergers on the credit markets. This issue is addressed by H.R. 4562, H.R. 5855, and H.R. 5517.

These bills deny the tax deductibility of credit used in merger takeovers. Clearly this is a problem. I hope this committee will look at each of those bills and come up with one which would be as tight as possible in denying this tax deductibility, if they are used for takeovers.

I don't want to come down on one side whether there ought to be a hostile takeover or not, but simply leave that up to your discretion.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF HON. TOM HARKIN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF IOWA

Mr. Chairman, I appreciate the opportunity to testify before the Subcommittee on Select Revenue Measures concerning the important question of merger taxation.

The number of mergers has been increasing dramatically. And the trend is likely to continue. The magazine Mergers and Acquisitions reported that there were $23.5 billion in transactions in the first quarter of this year, more than a 50 percent increase over the last quarter of 1981.

The mergers among corporate giants do not contribute to the growth of our nation; they do not stimulate our economy; they do not provide new jobs; they do not increase productivity.

Last year when President Reagan proposed, and this Congress approved, huge tax breaks to big business, it was with the belief and understanding that in order to get our economy moving again, companies would need large amounts of capital for new investments. It was argued that these investments would stimulate our economy, provide new jobs and increase our gross national product. We have yet to see the kinds of productive investments that were anticipated. Instead, a number of corporate giants have spent a great deal of time, energy, and money in the pursuit of other companies. The history of the growth of this country reflects what Americans are most proud of—American ingenuity. Where is that ingenuity now? It certainly does not lie in huge conglomerates gobbling each other up. The buying up of existing resources does nothing to get our ailing economy back on the road to health. And as long as it is economically more sensible for giant corporations to purchase companies with proven resources rather than to invest in the modernization and building of plants or in research and development, new jobs will not be created and our economy will continue to falter.

I believe that the Congress should do what it can to reduce the number of mergers. This committee can address three questions. First, what specific tax provisions in the code actually promote mergers, and can they be repealed or changed to reduce that unintended impact? Second, should the tax code contain specific provisions to dissuade mergers? And Third, should the code be changed to reduce the negative effects on interest rates and the ability to borrow caused by large sums being used for hostile takeovers?

On the first point, I believe that every effort should be made to remove tax provisions which provide benefits that promote large mergers. This issue is squarely met by the Chairman's bill, H.R. 6295. The bill does address some very complex areas of the tax code and eliminates provisions which have provided incentives to acquire companies simply for the tax benefit.

However, there is no doubt that attorneys will be searching to find ways around the provisions established by the bill. It is going to be very difficult to change the present reality that many on-going firms are worth more captured than free.

I would note that there are many other provisions which promote mergers. For instance, the minimum tax applies to certain types of businesses more than other. It may pay for those businesses to acquire firms which have proportionately fewer deductions subject to the tax.

I believe the Chairman is on the right track with H.R. 6295 and I applaud his efforts. However, we must realize that the tax code, by its nature, will always promote some mergers. Not every provisions that encourages mergers can be repealed or changed.

This brings us to the second question: should the tax code be used to actually restrain mergers? In the case of large mergers, I believe that it should. For decades, we have had anti-trust laws which have been designed to block mergers or acquisitions which would restrain trade and substantially reduce competition. I believe that anti-trust laws have been useful. However, we must admit that they are not always effective. In addition, as noted above, there are more problems with large mergers than restraint of trade.

From 1950 to 1976, the percent share of the assets of the 200 largest manufacturers increased from 47.7 percent to 58 percent of assets. Quite simply, small manufactuers are being squeezed out of the market place and the phenomenon of mergers between large companies accelerates that trend.

What makes this accelerating trend toward bigness most deplorable is the fact that small businesses account for most of the growth of new jobs in the U.S. The Small Business Committee reports that, in the first 8 years of the 1970s, employment grew by 9,583,000. During that time, the Fortune 1,000 companies increased employment by only 75,000 jobs, less than 1 percent of the total.

As mergers affect economic structure, they also affect our international trade position. Increasingly, we are finding ourselves behind in our trade with many countries. Perhaps part of the problem is the unwillingness or inability of our larger firms to adapt and be creative. The entrepreneurial force which made our country great is quite simply not as strong in our largest firms. Frankly, I believe a large part of the problem in our auto industry may be caused by this very point.

In the same way that the tax code hands out the carrots, it should also hold a stick. I do not believe that a merger provision should be so strong that it retards all mergers. Sometimes mergers are very useful. In some cases, it is the only effective way that ineffective managers can be dumped. I support an excise tax as a disincentive in the tax code which would counterbalance other provisions which promote mergers and add an additional disincentive.

The bill I introduced, H.R. 5719, creates a 15% excise tax on large mergers or acquisitions. It covers those mergers or acquisitions where a company with more than $2 billion in sales acquires a company with more than $200 million in sales. The 15% tax is based on actual sale price. Perhaps with a reduction on the pro-merger benefits which are in the code as contemplated in H.R. 6295, that figure could be lowered and have the effect intended.

The bill does exempt two categories of mergers. First, where the acquired entity is losing a substantial portion of its equity. Clearly, there are times when a choice must be made between merging or going out of business. The tax code should not artificially retard such mergers. The bill also exempts an acquisition from the tax if the acquisition would significantly improve a firm's ability to compete with substantial foreign competition. That decision would be made by the Secretary of the Treasury in consultation with the Secretary of Commerce.

Additionally, the bill provides for a 50% excise tax when an American firm with sales of over $200 million is acquired by an entity controlled by a foreign government. Americans buy firms overseas and foreigners buy firms in the United States. However, they all are united in the profit motive. When a foreign government acquires an interest in a concern in the United States, they do bring other interests. I believe that we should discourage such ownership of America's industrial base and a high excise tax on that type of transaction would help to avoid the problem.

There are those who would argue that the tax code should be neutral on the question of mergers, that it should be left to the free market. I would say that the tax code is not neutral now and never really will be neutral. It simply favors mergers in ways that are hidden and complex. We need to reverse that policy.

In addition to the structural benefits that our economy would enjoy from a reduction of merger activity, we would also see an increase in revenues which would reduce the government's deficit. An excise tax would generate substantial revenues. The provisions of H.R. 6295 close loopholes through which more billions are lost in tax deductions.

It is common for the price paid for a company to exceed the market value of its stock by 50 percent. That bonus price is, to a large extent, paid out of the United States Treasury.

The third area that should be examined is the effect of mergers on the credit markets. This issue is addressed by H.R. 4562, H.R. 5855 and H.R. 5517. These bills deny the tax deductibility of credit used in merger takeovers. Clearly, this is a problem. Some argue that money is fungible. A loan made for a merger is soon sent to stockholders who place it back into the money markets. However, the system is not so perfect. A large portion of the loans do not return to the financial institution quickly. Additionally, billions of dollars are set aside for possible merger activity by banks and are never used.

The problem is that loans made by large corporations may be exceedingly difficult to trace. Large corporations have numerous unsecured lines of credit and have considerable ability to move substantial funds internally.

I fear that, if passed, drafting the rules to make these provisions effective against large firms could prove to be very difficult.

I do strongly support the efforts to control this problem.

Chairman STARK. Thank you very much for taking the time to join us today. Your approach is indeed interesting; I am afraid that you have created 18 cases of indigestion in this room, with your suggestion of a 15-percent tax on mergers. But it is an idea that certainly gets right to the basis of determining whether or not there should be mergers.

Mr. Duncan.

Mr. DUNCAN. Thank you, Mr. Chairman. I want to thank our colleague. I just have one or two questions.

Do you agree with the bill's general philosophy that corporations should be taxed when they distribute appreciated assets?

Mr. HARKIN. I don't know. In some ways yes, and in some ways no.

Mr. DUNCAN. It is a tough question.

Mr. HARKIN. That is a tough question.

Mr. DUNCAN. Are you aware of any transactions now that would be affected by any of the bills that are being considered today?

Are you aware of any transactions going on now?

Mr. HARKIN. I am told that there are about 30 or 40 mergers a year that would be affected by my bill.

Mr. DUNCAN. You are not aware of any currently?

Mr. HARKIN. No, but I could give you the data. I am sure your staff could get you the data for what went on last year.

If there are some taking place right now, I don't know, Mr. Duncan. I am sorry.

Mr. DUNCAN. Thank you again for being here. We appreciate it. Thank you, Mr. Chairman.

Mr. HARKIN. My philosophy basically is that these large companies, as I said, with sales of over $2 billion taking over these smaller companies, there ought to be a tremendous burden on them before they can do it and I think right now everything tilts toward them acquiring and taking over these smaller companies.

I think the tilt ought to be the other way. I am not saying that all mergers are bad, but the burden of proof, the great burden, ought to be upon those that want to acquire these smaller companies.

Chairman STARK. Mr. Holland.

Mr. HOLLAND. Thank you, Mr. Chairman.

Tom, I thank you for your testimony and your idea.

You know, we on this committee understand whatever budget passes, and is eventually signed into law, that we are going to have to raise somewhere between $20 and $30 billion revenue under any budget. I am wondering if you have a number for us on how much revenue we would achieve out of the 15-percent tax which you suggest.

Mr. **Harkin**. We asked for some of these estimates. They gave us a range. They said in an average year $2 billion to $5 billion, in 1 year.

Mr. **Holland**. So it could be as much as 25 percent of our solution to our problem?

Mr. **Harkin**. It could be.

Mr. **Holland**. If we took a look at it.

Mr. **Harkin**. Especially if the merger activity continues as it has, and it seems like it is going to.

Chairman **Stark**. If the gentleman would yield, there was a little over $60 billion of acquisitions last year. I don't know how many of those would fall into the category of your 15-percent tax, but it is conceivable at that rate that even if half of them would qualify for the Harkins penny ante——

Mr. **Harkin**. That is $6 billion right there.

Chairman **Stark**. That is $6 billion right there.

Mr. **Harkin**. So I think the $2 to $5 billion probably is pretty solid.

Mr. **Holland**. I was about to suggest, Tom, that it is probably an idea that those old revenue enhancers running around town would be interested in if they are serious about balancing the budget at sometime in the future, and I think it is an idea that should be given some serious consideration.

I thank you for bringing it up.

Mr. **Harkin**. Thank you very much.

Chairman **Stark**. Mr. Heftel?

Mr. **Heftel**. I hope we don't start spending that money until we get it because if we think that tax-motivated merger activity will continue at the same rate with a 15-percent excise tax, we are sadly mistaken.

I think that such an excise tax will successfully discourage such merger activity, but I don't think an excise tax will raise much revenue.

I am delighted with your testimony because you are focusing on a problem that has to be addressed.

Have you in your testimony addressed the difference between acquisitions and mergers?

It appears that you have a 15-percent excise tax on both mergers and acquisitions.

Mr. **Harkin**. Both.

Mr. **Heftel**. In a merger you could have no applicable capital gains tax resulting in a very negative result for the Treasury by using a partial liquidation to step up the basis of assets in the acquired company, but were you intending to distinguish between the merger and the acquisition?

Mr. **Harkin**. Both the same.

Mr. **Heftel**. Both the same?

Mr. **Harkin**. Yes.

Mr. **Heftel**. Thank you very much.

Mr. **Holland**. I wonder if my colleague would yield on the point you made?

Mr. **Heftel**. Yes.

Mr. HOLLAND. Mr. Harkin, would you agree, though, that if this in effect put an end to tax-motivated mergers, the Treasury would certainly reap some large benefits?

Mr. HARKIN. Sure, even if it stopped it, I think that may be a good answer.

Mr. HOLLAND. It could be a tax to which temporarily at least there would be no escape?

Mr. HARKIN. I would hope so.

Mr. HEFTEL. There are some other ways of achieving that end result, though. Obviously we could eliminate that part of the code that gives you the tax advantage for the merger. We don't have to give a step up under any circumstances for the acquiring company in the assets of the acquired company, and so in effect we could continue mergers and discourage the tax incentive that is built into the code now.

Whether those mergers would continue in the absence of that provision doesn't matter, because Treasury would gain in fact, because the company that normally would have been paying tax would continue to pay tax because they wouldn't have the basis of the assets in the company they acquired stepped up.

Mr. HARKIN. I feel beyond the tax neutrality end of it alone, I beleive that we ought to take steps to discourage mergers. But, not to ban them.

Mr. HEFTEL. You have got two things: One is the tax consequences, and second is the social or philosophical policy involved in the merger.

Mr. HARKIN. That is right.

Mr. HEFTEL. You want to discourage mergers as much as you want to raise tax revenues for the Treasury?

Mr. HARKIN. That is true. As I said, I want to put a great burden on them. Like I said, not all are bad, and some could be beneficial, but there ought to be a tremendous burden on them if they want to merge or acquire another company, to show that it really is in the public interest.

Mr. HEFTEL. Thank you very much, Mr. Chairman.

Chairman STARK. Mr. Duncan.

Mr. DUNCAN. One other question, please. Your bill provides for $300 million of gross receipts; is that correct?

Mr. HARKIN. 200.

Mr. HEFTEL. 200.

Mr. HARKIN. $200 million in sales.

Mr. DUNCAN. How would that apply? Some business concerns have large gross receipts but a small markup or small profit. How would it apply in an instance like Braniff Airlines, who had perhaps that much receipts but did not make a profit, or some of the department stores that have gone bankrupt?

Mr. HARKIN. One, I said the bill does exempt two categories of mergers. First, where the acquired entity is losing a substantial portion of its equity. Just reading from my statement, "Clearly there are times when a choice must be made between merging or going out of business. The Tax Code should not artificially retard such mergers."

Also it would exempt an acquisition if they are able to compete better with a foreign entity. Braniff, I think, would fit into the exemptions.

Mr. DUNCAN. Your bill does provide for that situation?

Mr. HARKIN. Yes.

Mr. DUNCAN. A business losing money that is going out of business?

Mr. HARKIN. That is right.

Mr. DUNCAN. I like that part of your bill.

Chairman STARK. Thank you, Tom.

Mr. HARKIN. Thank you very much, Mr. Chairman. Good luck.

Chairman STARK. Just for the record, I was sent a letter by one of my constituents who enclosed a copy of a speech given before the Commonwealth Club in San Francisco in September of 1932 by Franklin Roosevelt. At that time Roosevelt was addressing the same thing, when he said:

> A careful study of the concentration of business in the United States shows that our economic life was dominated by some 600-odd corporations who control two-thirds of American industry. Ten million small business men divided the other third. More striking still, it appeared that if the process of concentration goes on at the same rate, at the end of another century we shall have all American industry controlled by a dozen corporations and run by perhaps 100 men.

He was saying the same thing.

Mr. DUNCAN. It is 500 now instead of 600.

Chairman STARK. I would like to call the Hon. David Glickman, Deputy Assistant Secretary of the Treasury for Tax Legislation.

Welcome, Mr. Secretary. If you would like to have any of your assistants join you at the witness table, you may. You have provided us with a written statement which will be put in the record in its entirety. You may read it or summarize it as you see fit.

STATEMENT OF HON. DAVID G. GLICKMAN, DEPUTY ASSISTANT SECRETARY, TAX POLICY, DEPARTMENT OF THE TREASURY

Mr. GLICKMAN. Thank you, Mr. Chairman. I am pleased to have the opportunity to present the views of the Treasury Department on a series of bills relating to corporate acquisitions. One bill would impose an excise tax on certain large acquisitions. Three would deny interest deductions for debts incurred to finance certain acquisitions, while the fifth, H.R. 6295, would make major structural changes to the corporate tax provisions of the Internal Revenue Code.

The Treasury Department does not believe that a merger excise tax or interest deduction limitation represents sound tax policy. Rather, we believe that, to the extent acquisitions in fact produce tax abuses, the solution lies with a structural reform of those tax rules which result in those abuses. Similarly, to the extent it is concluded that certain mergers should be discouraged generally, the solution should lie outside the tax laws.

Accordingly, I will discuss only briefly the first four of these bills, reserving the major portion of my testimony to an examination of H.R. 6295.

A summary of the bills and the Treasury Department's position on each is attached as an appendix to this statement.

H.R. 5719

H.R. 5719 imposes an excise tax of 15 percent and in certain situations 50 percent on certain large corporate acquisitions. H.R. 5719 is deficient in our judgment in numerous respects. First, the bill presumes that mergers among larger companies are uneconomic, unproductive transactions and therefore should be discouraged. In fact, mergers may benefit substantially the firms involved and the economy as a whole

It has also been argued that large mergers result in concentration of economic resources and therefore reduce the degree of competitiveness in the economy. Inquiries of this nature are properly made under the antitrust laws.

It may also be argued that some mergers produce inappropriate tax benefits to the acquiring entity. If this indeed is so, the solution lies in focusing directly on the benefits involved. In our view, an excise tax is not a suitable proxy for structural reforms of the tax rules governing mergers and acquisitions.

H.R. 5517

H.R. 5517 would deny deduction for interest on debt incurred to finance corporate acquisitions during a 2-year period during which the President determines that it is in the national interest to discourage the use or reservation of large blocks of credit to finance acquisitions.

H.R. 4562 AND H.R. 5855

H.R. 4562 and H.R. 5855 would deny all deduction for interest on debt whose proceeds are used in connection with an attempted—or successful—stock takeover of a corporation where the takeover is disapproved by a majority of the board of directors.

The premise of these bills is that the use of debt to finance acquisitions tends to reduce available credit for other uses. A further premise is that such scarce credit may be put to more productive use. In fact, use of debt to finance acquisitions does not reduce available credit.

Further, if the national policy is to discourage debt financed takeovers, or the reservation of credit for this purpose, we suggest that this would be done directly rather than through the tax system.

Finally, we do not believe that the board of directors of a target company should be able to cause a denial of an interest deduction because it does not agree with the purpose for which the funds are used.

H.R. 6295

I would now like to move into H.R. 6295. The first issue raised by H.R. 6295 concerns neutrality. Title I of this bill is designed, in part, to neutralize the tax consequences of transactions in which a corporation sells assets directly and those cases where the sale takes the form of a redemption of stock. The premise of these provisions is that, upon a corporate asset sale, gain or loss should be recognized by the selling corporation.

Specifically, sections 101 and 102 of the bill would repeal the general exemption from tax allowed to a corporation upon the distribution of its assets in partial liquidation.

Analogous to this corporate level appeal of the partial liquidation provisions, section 203 of the bill would substantially narrow the exemptions to the general rule which requires a corporation to recognize again on the distribution of appreciated property in redemption is stock by repealing certain of the exceptions in section 311(d)(2) of the code.

Section 104 of the bill concerns rules designed to prevent the avoidance of the partial liquidation repeal, which I just mentioned, through the use of either a section 355 spinoff or a section 351 incorporation.

Finally, section 202 of the bill also contains rules to prevent the use of section 337 to avoid recognition of gain on an asset sale.

The Treasury Department strongly supports the repeal of the section 311(d)(2) exceptions as well as the repeal of the partial liquidation provisions. In this regard, however, the subcommittee may also want to examine the propriety of retaining some of the other section 311(d)(2) exceptions to the recognition rule of section 311(d)(1).

We also wish to point out that the antiavoidance rules involving sections 355, 351 and 337, which I just mentioned, may prove to be too broad in application. We would hope to work with the subcommittee to sort out the situations which should or should not be covered.

SECTION 334(b)(2) RULES

Improvements with respect to section 334 (b)(2) of the code: Presently under section 334(b)(2) of the code, when a corporation (P) purchases 80 percent or more of the stock of a second corporation (T), P, upon liquidating T, will receive as its basis for T's assets its basis in the T stock purchased. The general purpose of section 344(b)(2) is to equate, for basis purposes, a purchase of stock followed by a liquidation with its functional equivalent, a direct purchase of assets.

While perhaps sound in theory, in practice section 334(b)(2) has resulted in a number of problems and abuses.

In section 201, H.R. 6295 would provide a solution to these problems. This section repeals section 334(b)(2), replacing it with a new section 338. Section 338 provides generally that, where P purchases at least 80 percent of the stock of T over a 12-month period, P may elect to step up the basis of the assets of T. Similarly, T will recapture those items liquidating corporations usually recognize under section 337. We understand that the gain attributable to the recapture cannot be offset by any losses or credits of P or its consolidated group, though the bill is not clear on this point.

The Treasury Department believes that the new section 338 makes substantial improvements to the code. It eliminates the requirement of a formal liquidation and treats with greater similarity the deemed asset purchase and the actual asset purchase. Thus, the acquired corporation's tax attributes are not available for use by the buyer, and the buyer's attributes are not available to offset the tax to the seller. Additionally, the messy and complicated basis adjustments required by an extended period of operations are avoided.

The next issue I would like to address is selectivity. H.R. 6295 contains a number of measures designed to prevent one corporation (P) acquiring a second (T) from being able to receive fair market value basis for some assets, while preserving T's tax attributes and historic basis for other assets.

This issue is sometimes referred to as selectivity. If P acquires all of T's assets, all would receive a fair market basis and T would recognize recapture items on all assets and its tax attributes would terminate. However, the recapture on certain assets may be insignificant in relation to the value of basis step-up, while the tax detriment attributable to the other assets may outweigh the value of a basis step-up. Under existing law, P and T may arrange their affairs so that P may step up the basis only of the desired assets at a cost of recapture on those assets. Further, under the consolidated return regulations, the actual tax liability associated with the recapture may be deferred or avoided.

H.R. 6295 attacks this situation in a number of ways. First, the bill exacts from T full gain recognition upon distribution of some—but not all—of its assets to P. Additionally, new section 338 limits selectivity by requiring basis step-up, with recapture, for the assets of all of T's subsidiaries if step-up is elected with respect to T's assets. Finally, a new section 346 is added to the code which, for those clever enough to avoid the foregoing rules, imposes a toll charge for basis step-up.

The Treasury Department recognizes that arguments may be made against allowing P a choice as to asset basis. First, in the partial liquidation context, it may be argued that present law allows avoidance of any tax consequences to the selection where P and T file a consolidated return. We agree that in some instances these results are inappropriate. However, depending on the abuse perceived, this matter may be one which can be handled administratively.

Second, it may be argued that a buyer should not be able to select to step up asset basis while not also being required to reduce asset basis when historic basis exceeds value. We agree that allowing a buyer to avoid the asset step-down is a discontinuity in the rules and could allow a buyer to realize built-in losses on acquired assets. However, Treasury does not believe this situation arises with sufficient frequency or is of sufficient magnitude to warrant a wholesale restructuring of the law.

Third, it may be argued that a pure change of corporate ownership should trigger a recapture of the corporation's tax deferrals and that, accordingly, recapture of depreciation and similar items should be required upon the acquisition of corporate control, presumably whether it is an asset acquisition or stock acquisition. We do not believe that, upon the disposition of a business, absence of recapture alone—provided basis is not stepped up—can be used as the principal justification for H.R. 6295.

The final argument is more amorphous. Although phrased in different ways, the points generally made are that a buyer should not get the best of both worlds, that is, maintenance of T's tax attributes and historic basis for some assets, with basis step-up and new cost recovery for others. Similarly, it is argued that an acquisition is either an asset acquisition or a stock acquisition but not both. It may also be argued that, as potential cost recovery deductions make some assets more valuable to buyers than to potential sellers, the tax laws provide incentives for corporate acquisitions. Allowing the buyer to achieve the desired results on certain assets, while avoiding unfavorable results on the others, may exacerbate this incentive.

If the perceived abuse is the ability of P to pick and choose—to obtain a basis step-up on some assets and avoid tax detriment with respect to others—the solution would be a very strict all-or-nothing approach. That is, upon any acquisition of control by P, or any acquisition of a substantial part of T's assets, stepped-up basis on any T asset could be achieved only at the cost of basis step-up (with recapture) on all of T's assets, including those held in susidiaries, with the termination of T's tax attributes. Although we hesitate to denigrate the ability of corporate tax planners to avoid any rule devised, we believe that a fairly tight all-or-nothing provision could be drafted.

However, the perceived abuse may not be that P can get a full basis on only certain assets, but rather that it can do so without a corporate level tax on the total realized appreciation. This result stems from the rule attributed to the 1935 Supreme Court case of *General Utilities and Operating Co.,* codified in section 311, 336 and 337, that a corporation recognizes no gain—in excess of certain recapture items—on distributions made to its stockholders.

Generally, outside of the corporate context, a buyer's ordinary deductions on acquired assets exceed the seller's ordinary income recognized on the sale. As a result, some assets become more valuable to buyers than to holders and the tax laws thus provide an impetus for their sale. However, where a substantial portion of the seller's tax is at ordinary income rates, that stimulus is relatively insubstantial. At the corporate level, however, because of the *General Utilities* doctrine and its progeny, the absence of tax in excess of recapture exacerates the incentive to sell.

The logical solution to this perceived abuse lies in the repeal of the *General Utilities* rule where the recipient receives a full fair market basis. On the one and, repeal would simplify greatly the tax laws. At this same time, however, consideration of repeal must necessarily take into account the dramatic impact of its consequences.

Repeal of *General Utilities* would mean that we will have a true double tax at the corporate and shareholder levels. To eliminate or mitigate this double tax, some integration of the corporate and shareholder taxes would be required. Although integration has been the subject of a great deal of discussion over the years, it is, of course, a highy complex and far-reaching change in the tax laws.

In the absence of integration, death would be the only means to avoid the two-tiered tax, and even then the corporate tax would continue to be applicable.

H.R. 6295 adopts a hybrid approach to the problem. As a general rule, the bill adopts the all-or-nothing philosophy. At the same time, however, H.R. 6295 creates an exception to that approach by repealing *General Utilities* in the partial liquidation and redemption context.

As in the direct sale context, we have identified certain problems arising from this hybrid approach.

Although the hybrid approach may prove effective in stopping the types of transactions identified to date, we fear that its built-in inconsistency reflects a conceptual weakness which will come back to haunt the tax system in years to come. Indeed, the problems identified in the operation of the antiavoidance rules indicate that the inconsistency of treatment will result in inappropriate results in particular cases. Further, the bill, by making distinctions in treatment between cases of complete and partial basis step-up, puts substantial pressure on the conditions in which buyers find their sellers, with the consequent arbitrariness of result and premium placed on tax planning and manipulation.

We appreciate the difficulty of the problems H.R. 6295 seeks to address. Chairman Stark and others who have worked on this bill have performed a substantial service in bringing the issues to the forefront and opening the public debate. We believe, however, that much more consideration should be given to these issues.

As we see it, the issues are whether or not selectivity should be permitted at all, whether the rule of *General Utilities* should be retained, or whether the present perceived abuses warrant the dramatic and radical change which either of the aforementioned alternatives contemplate.

Indeed, the *General Utilities* rule is of longstanding history and goes to the very fabric of subchapter C. In this regard, we appreciate the opportunity to assist this subcommittee in attempting to reach an appropriate solution.

I would now like to turn to the portion of the bill which concerns net operating losses and credits.

Section 301 of H.R. 6295 would amend the rules relating to limitations on the carryover of net operating losses and various credits. Although the Treasury Department recognizes that the rules now in effect may not be entirely satisfactory, we are concerned that the likelihood of trafficking in net operating losses and credits may not be sufficient to justify the consequences that, in certain situations, will result from enactment of section 301 of H.R. 6295.

For this reason, the Treasury Department believes that further study is necessary to determine the proper approach to be taken in limiting carryovers.

In taking this position, we do not want to understate the significance of the questions raised by altering the limitations imposed on the carryover of net operating losses and credits. The resolution of this issue could have a significant impact on the public's perception of the fairness of the tax law.

However, rules which unduly restrict the utilization of losses and credits could unfairly penalize investors who risk capital in unproven ventures. Such rules could deflect capital away from such investments.

Major changes to the rules governing the carryover of losses and credits enacted in 1976 have never become effective, in large part because no consensus has developed as to their appropriateness or that of any other set of rules.

Other groups have been examining this area since the 1976 amendments were enacted. We commend the chairman for delving into this most controversial and significant area. However, we seriously question whether the resolution of these problems contained in H.R. 6295 effectuates the purposes of the carryover rules to the maximum practical extent.

Under current law, a corporation that incurs a net operating loss in 1 year is generally permitted to use the loss to offset income earned in certain specified years prior to or after the year in which the loss was incurred. Similarly, a corporation may carry unused credits to other taxable years.

Section 382 of the present law was added to the Internal Revenue Code in 1954 to establish "objective" tests to be used to curb "trafficking" in corporations with unused net operating losses. Of particular concern was the perception that certain taxpayers were acquiring corporations whose principal asset was a net operating loss that could be applied in future years against income unrelated to the historic business of the acquired corporation.

By enacting section 382, Congress prevented taxpayers from treating the potential tax benefits inherent in unused net operating losses as assets that could be bought and sold. If net operating losses could be used without limitation, the tax law would encourage mergers and acquisitions as a means of obtaining the tax benefits of the net operating losses.

We believe that corporate takeovers should be evaluated on the economic merits of the acquisition. For this reason, we believe that Congress basic decision to restrict the transfer of net operating losses is essentially correct.

We recognize that many corporate acquisitions can be structured to avoid the application of the section 382 limitations in situations where there is a bona fide business purpose for the acquisition. Despite the existence of these well-defined methods for avoiding the application of section 382, the lurking presence of section 269 has discouraged taxpayers from entering into transactions that consisted principally of a transfer of tax benefits.

The proposed revisions to section 382 contained in section 301 of H.R. 6295 would implement many of the basic structural changes to section 382 contained in the 1976 act amendments while eliminating much of the undue complexity. The most significant of the proposed changes would close the well-defined avenues for avoiding the limitations imposed under current law. In essence, the degree of stock ownership would become the sole test for determining whether and to what extent limitations on loss carryovers will be imposed. The change of business requirement would be eliminated from section 382.

In evaluating the proposed changes to section 382, at the outset two fundamental questions must be considered.

First, should the ability to use net operating loss carryovers be determined solely by reference to the degree of continued stock ownership of the stockholders of the corporation that incurred the net operating losses?

Although the Treasury Department recognizes that the answer is not entirely free from doubt, at this time we are not prepared to state that any single objective factor fairly measures the degree to which net operating loss carryovers should be preserved.

We believe that it is necessary to explore alternative solutions to this problem before accepting a rule that may produce inappropriate results in certain situations.

Second, in those situations where it is appropriate to impose limitations on the use of the carryovers, should the amount of losses to be carried to subsequent years be reduced directly?

Again recognizing the difficulty of this question, the Treasury Department believes that imposing limitations based on the portion of income allocable to the continuing ownership of the shareholders of the loss corporation in the surviving corporate group should be examined to determine if it is preferable to limiting the losses to be carried to subsequent years.

First, I would like to talk about how the limitations should be imposed. In determining the circumstances in which the use of net operating loss carryovers should be restricted, it is important to consider the purpose for imposing limitations on the use of net operating loss carryovers.

Originally, the ability to carryover net operating losses was intended as an averaging device, that is, losses of a business in 1 year should be allowed to offset income of that business in a subsequent year. It is thus appropriate to limit the use of the carryovers to insure that they are not applied against income earned by an entity unrelated to the entity that generated the unused losses.

In devising limitations, however, care must be taken to insure that net operating losses resulting from such timing provisions as the accelerated cost recovery system are not routinely disallowed. Otherwise, income may be created as a result of the classic mismatching of income and deductions that the carryover rules are designed to eliminate.

Treasury is not suggesting that the carryover rules should serve the function of providing unconditional Federal subsidies of corporate losses, a purpose for which they were never intended. Although we recognize that the unrestricted use of net operating loss carryovers may make risk taking in corporate form more attractive, it is not clear that such risk taking is relatively discouraged under existing tax rules.

In addition, the unrestricted use of net operating loss carryovers would encourage the takeover of loss corporations by profitable corporations primarily to obtain the tax benefits of the loss carryovers. Such tax motivated mergers may have adverse economic consequences and should not be encouraged. If it is desirable to subsidize corporate losses, there are more efficient ways to accomplish this than by encouraging noneconomic mergers. Indeed, one of the purposes of the recently enacted safe harbor leasing provisions was to reduce the pressure to engage in such noneconomic activity.

Once it is accepted that some limitations are appropriate, it is necessary to determine the circumstances in which the limitation should be imposed. Unfortunately, it is quite difficult to establish a simple objective test to determine when the connection between the entity that generated the losses and the entity that earned income is sufficiently tenuous to justify the imposition of limitations.

However, I believe it is generally agreed that the following three criteria are most relevant in making this determination: the continuity of ownership which is the one criterion embodied in H.R. 6259; the continuity of business; and the contribution to earnings.

While we believe that none of these criteria works perfectly in all situations, we recognize that each of these criteria could be relevant to a determination of when limitations should properly be imposed. At this time, we are not prepared to endorse the adoption of any single criterion as the sole factor to be used in determining whether to impose limitations.

As I stated previously, H.R. 6295 relies upon continuity of interest as the sole touchstone for the application of section 382. Although continuity of interest is a significant factor, we are concerned that reliance on continuity of interest as the sole basis for imposing limitations may frustrate the purpose of the net operating loss provision as an averaging device.

This problem arises when net operating losses result from a taxpayer's ability to deduct expenses prior to the year in which the corresponding items of income must be reported, the significance of which was reduced by the enactment of the safe harbor rules presently in effect.

If net operating loss carryovers resulting from the acceleration of deductions against an asset's income stream are limited where the trade or business that generated the losses is continued, a serious mismatching of income may result.

This mismatching is illustrated in the following example. Assume that [illegible] formed corporation purchases equipment for $100 that [illegible] $10 of income every year for 20 years. Over the first 5 years [illegible] corporation will have, in aggregate, income of $50 and deductions [illegible] $100—this being equipment that under ACRS is written [illegible] the first 5-year period—leaving a net operating loss of [illegible] net operating loss should be available to offset income generated in future years. Otherwise, the corporation will not have obtained the full benefit of its cost recovery deduction.

If after 5 years the stock of the corporation is acquired in a nontaxable reorganization by a second corporation as a result of which the old shareholders of the loss corporation received less than 20 percent of the stock of the surviving corporation, the bill would eliminate the net operating loss carryover. Such a result prevents the averaging of the tax accounting losses incurred in the early years against the income of the later years.

The second question is how to limit carryovers. If a sufficient change of stock ownership has occurred between the year in which the net operating loss was incurred and the year to which the loss is to be carried, H.R. 6295 would limit the benefit of the carryovers by reducing the net operating loss that may be carried to all subsequent years.

As we have previously illustrated, use of this loss limitation rule may prevent a business from obtaining the full benefit of its cost recovery deductions.

Under an income-based method, the acquiring corporation would be able to carry the net operating losses in full to the postacquisition years. However, the acquiring corporation would be able to apply the losses against only a limited percentage of the income for the year. The limited percentage would equal the percentage by which net operating losses would be reduced under rules analogous to those contained in H.R. 6295. In essence, the acquiring corporation would be treated as a joint venture of the loss corporation and the acquiring corporation.

Under both limitations, a corporation would have much less of an incentive to acquire a loss corporation than exists under the current section 382 rules. In application, the difference between the two approaches would be that under an income based method the extent to which the net operating losses may be used depends on the income allocable to the loss corporation. If the allocable share of income is very high, the full net operating loss carryover would be used very quickly. If the allocable share of income is low, then the net operating loss carryovers may be used more slowly than they would under the loss limitation rule and may have less present value than the immediate utilization of a reduced carryover contemplated by the bill.

Under the income limitation approach, the acquiring corporation is more likely to be able to use the net operating loss carryovers generated by accelerated deductions against the income properly allocable to such income.

For this reason, the income limitation rule deserves to be examined more closely to see if it represents a significant improvement over the loss limitation rule included in H.R. 6295.

Another provision of the bill concerns F reorganizations involving multiple corporations.

Section 368 defines an F reorganization as "a mere change in identity, form, or place of organization." In recent years, the courts have held that an F reorganization may involve the combination of multiple operating companies.

A number of rules in the Internal Revenue Code, however, are premised on the assumption that an F reorganization may involve only a single entity. Section 302 of the bill would expressly limit F reorganizations to cases involving a single corporation. The Treasury Department supports this change as a means of maintaining the integrity of these existing code rules.

One important feature of this issue, however, involves the availability of net operating loss carrybacks. The code provides that, except in an F reorganization, postreorganization losses of an acquiring corporation may not be carried back to a prereorganization year of a transferor corporation. In light of the fact that the proper treatment of net operating loss carryovers is to be considered carefully in the coming months, we believe that consideration should also be given to the treatment of net operating loss carrybacks in the overall scheme. Such overall consideration, we believe, can only lead to a well-reasoned treatment of this entire area.

Finally, I would like to mention a few items which perhaps deserve the future consideration of this subcommittee.

Other problems in the corporate area have been identified which we believe warrant legislative consideration. Examples are situations involving the formation of holding companies and the interrelationship of sections 304 and 351 of the code and the disparate definition of various forms of reorganizations under section 368.

We also suggest that consideration be given to remedying certain of the problems that have been encountered with respect to section 367.

The questionable judicial interpretation of section 367 in some of the recent cases has created considerable uncertainty as to the criteria to be considered in determining the existence of a tax avoidance purpose for a transfer. We suggest in this regard that an objective standard be adopted which would reflect the original intent behind that section.

We would be pleased to assist the committee in exploring solutions to these problems.

Mr. Chairman, again the Treasury Department wants to commend you and this committee for considering these important areas. I would be happy to answer any questions you might have.

[The prepared statement follows:]

For Release Upon Delivery
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STATEMENT OF DAVID G. GLICKMAN
DEPUTY ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE SUBCOMMITTEE ON SELECT REVENUE MEASURES
HOUSE COMMITTEE ON WAYS AND MEANS

Mr. Chairman and Members of the Subcommittee:

I am pleased to have the opportunity to present the views of the Treasury Department on a series of bills relating to corporate acquisitions. The underlying theme of these bills is that certain acquisitions are inappropriate as a matter of policy, or produce undue tax benefits, and therefore should be discouraged. One bill (H.R. 5719) would impose an excise tax on certain large acquisitions, three (H.R. 5517, H.R. 4562, and H.R. 5855) would deny interest deductions for debt incurred to finance certain acquisitions, while the fifth (H.R. 6295) would make major structural changes to the corporate tax provisions of the Internal Revenue Code.

The Treasury Department does not believe that a merger excise tax or interest deduction limitation represents sound tax policy. Rather, we believe that, to the extent acquisitions in fact produce tax abuses, the solution lies with a structural reform of those tax rules which result in those abuses. Similarly, to the extent it is concluded that certain mergers should be discouraged generally, the solution should lie outside the tax laws.

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Accordingly, I will discuss only briefly the first four of these bills, reserving the major portion of my testimony to an examination of H.R. 6295.

A summary of the bills and the Treasury Department's position on each is attached as an appendix to this statement.

H.R. 5719 -- Excise Tax on Certain Acquisitions of Business Entities

H.R. 5719 imposes an excise tax on certain large corporate acquisitions. The tax applies to acquisitions (1) where one entity has gross receipts in excess of $2 billion and the other receipts in excess of $300 million for the preceding taxable year; and (2) where the acquiring entity acquires, within an 18-month period, 50 percent of the voting stock of the acquired entity, 35 percent of such stock with a value of $150 million, or assets having a value of $150 million. The tax is 15 percent of the value of the consideration (50 percent where the acquiring entity is owned or controlled by a foreign government) and is imposed on the acquiring entity. Exceptions apply where the acquired entity had a net operating loss for the previous taxable year at least equal to 3 percent of its assets, or an aggregate net operating loss for the 4 preceding taxable years equaling 10 percent or more of its assets. Additionally, the tax will not apply to any acquisition where the Secretary of the Treasury, after consultation with the Secretary of Commerce, determines that imposition of the tax is inappropriate because the increased resources resulting from the acquisition significantly improve the acquired entity's ability to compete with foreign competitors.

H.R. 5719 is deficient in numerous respects. First, the bill presumes that mergers among larger companies are uneconomic, unproductive transactions and therefore should be discouraged. In fact, mergers may benefit substantially the firms involved and the economy as a whole. A merger makes available to the acquired company additional resources, thus reducing its cost of funds and enhancing its ability to compete. Indeed, the bill recognizes this by exempting mergers which enhance competition with foreign entities.

Moreover, if mergers are uneconomic or unproductive, imposing an excise tax is not an appropriate solution. Rather, the marketplace will sufficiently penalize the uneconomic combination.

It has also been argued that large mergers result in concentration of economic resources and thereby reduce the degree of competitiveness in the economy. This is not a tax issue. Rather, inquiries of this nature are properly made under the antitrust laws. Indeed, mergers of firms as large as those which fall within this proposal are generally scrutinized for anticompetitive results by the Antitrust Division of the Justice Department or the Federal Trade Commission.

It may also be argued that some mergers produce inappropriate tax benefits to the acquiring entity. If this indeed is so, the solution lies in focusing directly on the benefits involved. In our view, an excise tax is not a suitable proxy for structural reform of the tax rules governing mergers and acquisitions.

H.R. 5517 -- Disallowance of Interest Deduction on Acquisition Debt Where President Determines that Use of Such Debt Should Be Discouraged; H.R. 4562, 5855 -- Disallowance of Interest Deduction For Loans Incurred in "Unfriendly" Takeovers

Section 279 of the Code presently disallows as a deduction, under very limited circumstances, interest payments in excess of $5 million with respect to certain corporate debt incurred to acquire stock or assets of a second corporation. H.R. 5517 would amend section 279 to provide that such acquisition debt will include obligations issued during a 2-year period during which the President determines that it is in the national interest to discourage the use or reservation of large blocks of credit to finance acquisitions.

H.R. 4562 and 5855 would deny all deduction for interest on debt whose proceeds are used in connection with an attempted (or successful) stock takeover of a corporation where the takeover is disapproved by a majority of the board of directors.

The premise of these bills is that the use of debt to finance acquisitions tends to reduce available credit for other uses. A further premise is that such scarce credit may be put to more productive use.

In fact, use of debt to finance acquisitions does not reduce available credit. The proceeds of those loans are transferred to the acquired corporation or its shareholders, who in turn deposit the amounts in banks, make direct loans, or otherwise acquire assets. Further, if the national policy is to discourage debt-financed takeovers, or the reservation of credit for this purpose, we suggest that it be done directly, rather than through the tax system in the form of denial of the interest deduction.

Further, with respect to debt incurred to finance unfriendly takeovers, we do not believe it is sound tax policy to deny an interest deduction solely because an unrelated party (the board of directors of the target corporation) disagrees with the purposes for which the funds will be used.

H.R. 6295 -- Corporate Takeover Tax Act

Neutrality

Title I of the bill is designed, in part, to neutralize the tax consequences of transactions in which a corporation sells assets directly and those cases where the sale takes the form of a redemption of stock. The premise of these provisions is that, upon a corporate asset sale, gain or loss should be recognized by the selling corporation. Such gain should not escape taxation merely because the sale has taken the form of a stock transaction. Recent transactions in which buyers have purchased blocks of a corporation's stock which they subsequently exchanged for assets of the corporation, the latter claiming nonrecognition on the transaction, have brought into focus the tax avoidance possibilities which may arise under present law.

The Treasury Department strongly supports remedial legislation in this area. We believe that, even under existing law, the Internal Revenue Service has the authority to recharacterize some of these transactions as asset sales by the corporation -- with attendant recognition of gain or loss -- and that such recharacterization would be sustained by the courts. With respect to certain other of these transactions, however, present law may provide nonrecognition to the selling corporation. We believe the certainty which would be achieved by this legislation, as well as the extension of the rules to cover other transactions, to be salutary developments in the tax law.

Specifically, sections 101 and 102 of the bill would repeal the general exemption from tax allowed to a corporation upon the distribution of its assets in partial liquidation. To allow shareholders who receive certain distributions formerly qualifying as partial liquidations to continue to be accorded sale or exchange treatment, a new section 302(e) would be added to the Code, providing that a distribution attributable to the cessation of an active trade or business (now described in section 346(b)) will be treated as not essentially equivalent to a dividend for purposes of section 302.

Analogous to this corporate level repeal of the partial liquidation provisions, section 103 of the bill would substantially narrow the exceptions to the general rule which requires a corporation to recognize gain on the distribution of appreciated property in redemption of stock. Section 103 would repeal section 311(d)(2)(A) of the Code, which insulates distributions in complete redemption of a 10-percent shareholder; (d)(2)(B), which excepts distributions of stock or debt of certain subsidiaries; (d)(2)(C), which excepts distributions of stock or securities made pursuant to an antitrust decree; and (d)(2)(G), which insulates stock distributions made to effectuate the terms of the Bank Holding Company Act.

Section 104 of the bill contains rules designed to prevent avoidance of the partial liquidation repeal. Specifically, the bill would require recognition of gain or loss on a complete liquidation if, at any time within the prior 5 years, the corporation was the distributing or controlled corporation in a separation to which section 355 applied. This rule is designed to prevent a corporation from incorporating assets and then distributing the stock to its shareholders, who may then sell the stock of either corporation. In the absence of section 104, the buyer would be entitled to nonrecognition upon the subsequent liquidation of the acquired corporation; yet, the net result would be the same as if the assets had been sold directly to the buyer, with no gain recognition to the corporate seller.

Similarly, section 104 provides that gain or loss will be recognized on a complete liquidation if the liquidating corporation had transferred assets to subsidiary in an exchange to which 351 applies within 5 years of the liquidation. This rule is intended in part to prevent a seller from insulating assets in a subsidiary and then liquidating with the shareholder selling the directly held assets. In the absence of such a rule, this transaction may enable the corporation to effectuate an asset sale with no gain at the corporate level.

Section 202 of the bill also contains rules to prevent the use of section 337 to avoid recognition of gain on an asset sale. Specifically, section 202 provides that gain or loss will be recognized upon the sale or exchange of the assets of any subsididary unless the entire affiliated group of which such subsididary is a member completely liquidates. This rule is designed, in part, to prevent corporations from shifting assets within the same affiliated group preparatory to a sale of only certain assets. In the absence of such a rule, nonrecognition at the corporation level may be achieved on the sale of certain assets while the shareholders retain the same corporate configuration.

The Treasury Department strongly supports the repeal of these section 311(d)(2) exceptions as well as the repeal of the partial liquidation provisions. In this regard, however, the Committee may also want to examine the propriety of retaining some of the other section 311(d)(2) exceptions to the recognition rule of section 311(d)(1).

We also wish to point out that the anti-avoidance rules may prove too broad in application. For example, the section 355 rule may require gain recognition in what essentially is a complete liquidation. To illustrate, corporation T incorporates certain assets in subsididary S and distributes the S stock to its sole shareholder A. In an unrelated transaction, A subsequently sells the S stock, with the result that A now holds only the T stock. If A also causes T to liquidate within 5 years of the distribution, T will recognize gain on the liquidation, even though, with respect to A, a complete liquidation of the pre-distribution enterprise has occurred. We do not believe that the purposes of the rule require gain recognition in this context.

Similarly, the 351 rule may cause inappropriate results in this context. To illustrate, if corporation T segregates assets in a subsidary, upon liquidation T's shareholder A will recognize full capital gain and T will recognize gain on the distributed assets as well as the distributed stock. Even if A subsequently sells the directly held assets to P, the penalty to A (shareholder capital gain and corporate gain on the stock retained) is more severe than that exacted in the partial liquidation context. Further, this tax is exacted even though A subsequently liquidates S and thus has completely liquidated his interest in the corporate enterprise.

In the section 337 context, T, upon sale of a subsidiary's assets must recognize gain unless the entire group is liquidated. We question whether this rule also goes too far. The section 337 route is not a complete substitute for the partial liquidation or section 311 transaction. Under section 337, the T shareholders must recognize gain on their entire stock interest upon the liquidation. Accordingly, we question whether a complete liquidation of all subsidiaries is always necessary to prevent use of section 337 as an avoidance device.

Improvement to Section 334(b)(2) Rules.

Presently, under section 334(b)(2) of the Code, when a corporation (P) purchases 80 percent or more of the stock of a second corporation (T) over a 12-month period, P, upon liquidating T, will receive as its basis for the T's assets its basis in the T stock purchased. The general purpose of section 334(b)(2) is to equate, for basis purposes, a purchase of stock followed by a liquidation with its functional equivalent, a direct purchase of assets. Correlatively, T will be taxed on certain recapture items (e.g. certain recovery deductions on real or personal property, investment tax credit (ITC), the recapture amount attributable to LIFO inventory, and gain on certain installment obligations).

While perhaps sound in theory, in practice section 334(b)(2) has resulted in a number of problems and abuses. First, the required actual liquidation may be difficult and complicated, thus proving to be an obstacle in effectuating the basis step-up. Further, under present law, up to 5 years may elapse between the acquisition of control and the completion of the liquidation. In the interim, P, by filing a consolidated tax return with T, may make use of the T's tax attributes. When T is liquidated, any recognized gain may be absorbed by losses or credits of the consolidated group. Also, since T will be an ongoing, operating company prior to liquidation, adjustments to asset basis are necessary to reflect T's earnings, losses, or distributions to shareholders. The adjustments now required are extremely complicated and, in some cases, may result in increases to basis which may not be appropriate.

In section 201, H.R. 6295 would provide a solution to these problems. This section repeals section 334(b)(2), replacing it with a new section 338. Section 338 provides generally that, where P purchases at least 80 percent of the stock of T over a 12-month period, P may elect to step up the basis of the assets of T. This election is made 60 days after the close of the 12-month period and is irrevocable. If the election is made, T is treated as having sold all of its assets to a new corporation on the date 80 percent ownership is achieved in a transaction described in section 337. The price deemed paid is P's basis in the T stock at the close of the 12-month period. Similarly, T will recognize the items liquidating corporations usually recognize under section 337 (recapture, etc.) based on this hypothetical purchase price. We understand that the gain cannot be offset by any losses or credits of P or its consolidated group, though the bill is not clear on this point.

The Treasury Department believes that the new section 338 makes substantial improvements to the Code. It eliminates the requirement of a liquidation and treats with greater similarity the deemed asset purchase with the actual asset purchase. Thus, the acquired corporation's tax attributes are not available for use by the buyer, and the buyer's attributes are not available to offset the tax to the seller. Additionally, messy and complicated basis adjustments required by an extended period of operations are avoided.

We would like to address a few technical problems which arise in the operation of new section 338. First, the section provides that the sale is deemed to be made on the date 80-percent ownership is achieved, but the price deemed to be paid is P's stock basis at the close of the 12-month acquistion period. We understand that it is intended that asset basis will not have to be adjusted to reflect T's operations during the period between acquisition of control and the close of the period. We believe this point should be clarified, especially since a purpose of the provision is to avoid the complexities of the adjustments required under present law.

Second, under new section 338, if P acquires less than 100 percent of T, the basis step-up, and consequent recapture to T, will be based only on P's interest. Thus, if P acquires 80 percent of the T stock, T's assets will be stepped up to 80 percent of value and T will recognize 80 percent of the recapture items. However, this proportionate basis step-up rule may present significant administrative problems in allocating purchase price to asset basis. An alternative approach could be to accord to T's assets a full fair market value basis, with attendant recapture. This rule, however, presents the discontinuity that asset basis is provided in excess of the consideration furnished for the acquisition. The accompanying recapture, however, imposes some cost on the benefit of the increased basis. Since this cost may be considered insufficient, a variation would be to require full gain recognition to T with respect to the portion of the step-up in excess of P's stock basis. The full basis rule will prevent the need for later adjustments if P acquires additional stock of T, and simplifies greatly administration of the basis allocation. A final possibility would be to require 100 percent acquisition for the section 338 election to apply. Since the existence of minority shareholders tends to be a problem for the majority, we think that most section 338 transactions would become 100 percent acquisitions in any event.

On balance, we have difficulty in allowing a full step-up in basis where only 80 percent of the stock has been acquired with only attendant recapture. Thus, we prefer the proportionate basis rule presently provided, despite the complexity. We also consider the full basis step-up with gain recognition on the portion of the assets attributable to minority ownership to be an acceptable alternative.

Selectivity.

H.R. 6295 also contains a number of measures designed to prevent one corporation (P) acquiring a second (T) from being able to receive fair market value basis for some assets (with attendant recovery deductions), while preserving T's tax attributes and historic basis for other assets. The situation focused on is one where T has certain high value, low basis assets which are more valuable to a purchaser than to T by reason of the latter's ability to take cost recovery allowances on a full fair market basis. If P acquires all of T's assets, all would receive a fair market basis and T (assuming adoption of a section 337 plan of liquidation) would recognize recapture items on all assets and its tax attributes would be terminated. However, the recapture on the desired assets may be insignificant in relation to the value of basis step-up, while the tax detriment attributable to the other assets (recapture, etc.) may outweigh the value of a step-up to a full fair market value basis. Under existing law, P and T may arrange their affairs so that P may step up the basis only of the desired assets at a cost of recapture on those assets. Further, under the consolidated return regulations, the actual tax liability associated with the recapture may be deferred or avoided. At the same time, T will retain its historic basis and other tax attributes for the other assets, while avoiding their recapture elements.

H.R. 6295 attacks this situation in a number of ways. First, by repeal of the partial liquidation provisions and certain of the section 311(d)(2) exceptions, the bill exacts from T full gain recognition (not just recapture) on distributed assets upon distribution of some (but not all) of its assets to P. Additionally, new section 338 limits selectivity by requiring basis step-up (with recapture) for the assets of all of T's subsidiaries if step-up is elected with respect to T's assets. Section 337 is amended to provide somewhat similar results in the case of direct asset sales where the sold assets include the stock of subsidiaries. In order to prevent T from achieving selectivity in the liquidation context, section 104 of the bill requires gain recognition to be triggered in a complete liquidation if assets have been insulated in a subsidiary in a section 351 exchange within 5 years of the liquidation. Finally, a new section 346 is added to the Code which, for those clever enough to avoid the foregoing rules, imposes a "toll charge" for basis step-up. Specifically, new section 346 provides that there will be no basis step-up unless the distributing corporation triggers recapture on all assets as if a section 337 sale had occurred, or recognizes gain on the distributed assets.

The Treasury Department recognizes that arguments may be made against allowing P a choice as to asset basis, albeit with attendant tax consequences. First, in the partial liquidation context it may be argued that present law allows avoidance of any tax consequences to the selection where P and T file a consolidated tax return. Section 1.1502-14 (c) of the consolidated return regulations provides generally that gain recognized on a partial liquidation will be deferred by the distributing corporation. The deferred gain is treated as arising from an intercompany transaction and therefore is taken into account by the distributing corporation under section 1.1502-13 (d), (e), and (f). Generally, these provisions require recapture of the deferral against later cost recovery deductions on the distributed property, or when the property or the selling or purchasing member leaves the group. Further, § 1.1502-31 (b) (2) (ii) provides that, in a partial liquidation, the basis of the property received by the distributee corporation is the same as the basis of the stock exchanged. Section 1.1502-3 (f) (2) (i) of the regulations provides that there is no ITC recapture when property is distributed from one member of a group to another in a partial liquidation.

We agree that in some instances these results are inappropriate. However, depending on the abuse perceived, this matter may be one which can be handled administratively.

Secondly, it may be argued that a buyer should not be able to select to step up asset basis (with consequent tax advantages) while not also being required to reduce asset basis (with consequent tax detriment) when historic basis exceeds value. We agree that allowing a buyer to avoid the asset step-down is a discontinuity in the rules and could allow a buyer to realize built-in losses on acquired assets. However, we do not believe this situation arises with sufficient frequency or to be of sufficient magnitude to warrant a wholesale restructuring of the law. Indeed, with the availability of ACRS deductions, assets will generally not have a basis in excess of value.

Thirdly, it may be argued that a change of corporate ownership should trigger a recapture of the corporation's tax deferrals and that, accordingly, recapture of depreciation and similar items should be required upon the acquisition of corporate control. Conversely, it may be argued that the purpose of the recapture rules is to prevent the "churning" of assets -- i.e., allowing a buyer to enjoy the benefit of cost recovery deductions on a stepped-up basis, without appropriate toll charge to the seller. Present law does exact this toll charge -- when a buyer receives a stepped-up basis, recapture is generally imposed on the corporate seller. Whatever the correct answer, the issue is sufficiently close that we do not believe that, upon the disposition of a business, absence of recapture alone -- provided basis is not increased -- can be used as the principal justification for H.R. 6295.

The final argument is more amorphous. Although phrased in different ways, the points generally made are that a buyer should not get the best of both worlds, i.e., maintenance of T's tax attributes and historic basis for some assets, with basis step-up and new cost recovery for others. Similarly, it is argued that an acquisition is either an asset acquisition (full basis with recapture, termination of tax attributes) or a stock acquisition (historic basis, no recapture, continuation of tax attributes), but not both. It may also be argued that, as potential cost recovery deductions make some assets more valuable to buyers than to potential sellers, the tax laws provide incentives for corporate acquisitions. Allowing the buyer to achieve the desired results on certain assets, while avoiding unfavorable results on the others, may exacerbate this incentive. Similarly, if the buyer could not pick and choose as to the consequences, tax-motivated transfers would be impeded.

If the perceived abuse is the ability of P to pick and choose -- to obtain step-up on some assets and avoid tax detriment with respect to others -- the solution would be a very strict all or nothing approach. That is, upon any acquisition of control by P, or any acquisition of a substantial part of T's assets, stepped-up basis on any T asset could be achieved only at the cost of basis step-up (with recapture) on all of T's assets, including those held in subsidiaries, with the termination of T's tax attributes. Distributions from T to P either would not result in basis step-up with respect to the distributed assets (*i.e.*, all intercorporate distributions, including those covered in the new section 302(e), would be treated as dividends), or would trigger basis step-up and recapture with respect to all assets. Although we hesitate to denigrate the ability of corporate tax planners to avoid any rule devised, we believe that a fairly tight all or nothing provision could be drafted.

However, the perceived abuse may not be that P can get a full basis on only certain assets, but rather that it can do so without a corporate level tax on the total realized appreciation. This result stems from the rule attributed to *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935), now codified in sections 311(a), 336, and 337, that a corporation recognizes no gain (in excess of certain recapture items) on distributions, including liquidating distributions, made to its stockholders. Generally, outside of the corporate context, a buyer's ordinary deductions on acquired assets exceed the seller's ordinary income recognized on the sale. As a result, some assets become more valuable to buyers than to holders and the tax laws thus provide an impetus for their sale. However, where a substantial portion of the seller's tax is at ordinary income rates, that stimulus is relatively insubstantial. At the corporate level, however, because of the *General Utilities* doctrine and its progeny, the absence of tax in excess of recapture exacerbates the incentive to sell.

The logical solution to this perceived abuse lies in the repeal of the *General Utilities* rule where the recipient receives a full fair market basis. On the one hand, repeal would simplify greatly the tax laws. For example, the extraordinarily complex rules of section 341 relating to collapsible corporations would probably no longer be necessary. At this same time, however, consideration of repeal must necessarily take into account the dramatic impact of its consequences. Repeal of *General Utilities* would mean that we will have a true double tax at the corporate and shareholder levels. To eliminate or mitigate this double tax, some integration of the corporate and shareholder taxes would be required. Although integration has been the subject of a great deal of discussion over the years, it is, of course, a highly complex and far reaching change in the tax laws. In the absence of integration, death would be the only means to avoid the two-tiered tax, and even then the corporate tax would continue to be applicable.

H.R. 6295 adopts a hybrid approach to the perceived problems. As a general rule, the bill adopts the all or nothing philosophy, i.e., if the basis of some acquired assets is stepped up, all must be stepped up, but at the cost of recapture. The rules of section 338 and certain of the changes made to section 337 are designed to achieve this overall scheme.*/ At the same time, however, H.R. 6295 creates an exception to this approach by repealing General Utilities in the partial liquidation and redemption contexts. Under the bill, P may cause a distribution of some of T's assets and achieve a corresponding basis step-up, and still enjoy a continuation of T's historic basis and tax attributes. The cost, however, is full gain recognition at the corporate level on the distributed assets.

As in the direct sale context, we have identified certain problems arising from this hybrid approach. For example, the rules seem to work unfairly when T or its shareholder (A) completely sell out, but to unrelated buyers. To illustrate, corporation T is a holding company with two subsidiaries, R and S. T sells all of the stock of R to corporation X and causes S to sell all of its assets to corporation Y. T then causes S to liquidate, and T itself liquidates. Under the bill, the sale of S 's assets to Y is entitled to nonrecognition under section 337 only if X liquidates R. However, since T has disposed of all of its properties and has liquidated, we do not see why the availability of section 337 treatment should depend on X's actions with respect to R. Even if all of T's assets are sold to Y, using the format described above, we question whether section 337 should be the proxy to prevent selectivity. Similarly, under the section 355 rule, where the stock of distributing (T) is sold to X and the stock of controlled (S) to Y, gain would be recognized on the complete liquidation of either corporation, even though A's interest has terminated. Further, the section 351 rule exacts corporate gain recognition and shareholder tax up front, even if A sells all distributed properties to different purchasers.

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*/As drafted, H.R. 6295 still leaves considerable opportunity to avoid the all or nothing approach. The Description prepared for this Hearing by the Staff of the Joint Committee on Taxation suggests amendments to the bill which would limit these opportunities.

Where T or A completely sell out to a single purchaser (P), the rules also may produce some bizarre results. For example, if after a separation, A in an unrelated transaction sells the stock of both corporations to P, which subsequently liquidates each, full gain will be recognized to the liquidating corporations. Similarly, if A liquidates T after a section 351 exchange (which liquidation results in a full tax to A) and sells all distributed properties to P, full corporate level gain will have been recognized by T even though with respect to A a complete liquidation has occurred.

Although the hybrid approach adopted by H.R. 6295 may prove effective in stopping the types of transactions identified to date, we fear that its built-in inconsistency reflects a conceptual weakness which will come back to haunt the tax system in years to come. Indeed, the problems identified in the operation of the anti-avoidance rules indicate that the inconsistency of treatment will result in inappropriate results in particular cases. Further, the bill, by making distinctions in treatment between cases of complete and partial basis step-up, puts substantial pressure on the conditions in which buyers find their sellers, with the consequent arbitrariness of result and premium placed on tax planning and manipulation.

We appreciate the difficulty of the problems H.R. 6295 seeks to address. Chairman Stark and others who have worked on this bill have performed a substantial service in bringing the issues to the forefront and opening the public debate. We believe, however, that much more consideration should be given to these issues. As we see it, the issues are whether or not selectivity should be permitted at all, whether the rule of General Utilities should be retained, or whether the present perceived abuses warrant the dramatic and radical change which either of the aforementioned alternatives contemplate. Indeed, the General Utilities rule is of long-standing history, and goes to the very fabric of subchapter C. In this regard, we appreciate the opportunity to assist this Subcommittee in attempting to reach an appropriate solution.

Limitations on Net Operating Losses and Credits

Section 301 of H.R. 6295 would amend the rules relating to limitations on the carryovers of net operating losses and various credits. Although the Treasury Department recognizes that the rules now in effect may not be entirely satisfactory, we are concerned that the likelihood of trafficking in net operating losses and credits may not be sufficient to justify the consequences that, in certain situations, will result from enactment of Section 301 of H.R. 6295. For this reason, the Treasury Department believes that further study is necessary to determine the proper approach to be taken in limiting carryovers.

In taking this position, we do not want to understate the significance of the questions raised by altering the limitations imposed on the carryover of net operating losses and credits. The resolution of this issue could have a significant impact on the public's perception of the fairness of the tax law. However, rules which unduly restrict the utilization of losses and credits could unfairly penalize investors who risk capital in unproven ventures. Such rules could deflect capital away from such investments.

Major changes to the rules governing the carryover of losses and credits enacted in 1976 have never become effective, in large part because no consensus has developed as to their appropriateness or that of any other set of rules. Other groups have been examining this area since the 1976 amendments were enacted. We commend the Chairman for delving into this most controversial and significant area. However, we seriously question whether the resolution of these problems contained in H.R. 6295 effectuates the purposes of the carryover rules to the maximum practical extent. We think that additional time should be spent to see if a better solution can be devised.

Under current law, a corporation that incurs a net operating loss in one year is generally permitted to use the loss to offset income earned in certain specified years prior to or after the year in which the loss was incurred. Similarly, a corporation may carry unused credits to other taxable years.

Section 382 was added to the Internal Revenue Code in 1954 to establish "objective" tests to be used to curb "trafficking" in corporations with unused net operating losses. Of particular concern was the perception that certain taxpayers were acquiring corporations whose principal asset was a net operating loss that could be applied in future years against income unrelated to the historic business of the acquired corporation. By enacting section 382, Congress prevented taxpayers from treating the potential tax benefits inherent in unused net operating losses as assets that could be bought and sold. If net operating losses could be used without limitation, the tax law would encourage mergers and acquisitions as a means of obtaining the tax benefits of the net operating losses. We believe that corporate takeovers should be evaluated on the economic merits of the acquisition. For this reason, we believe that Congress' basic decision to restrict the transfer of net operating losses is essentially correct.

Section 382, as presently in effect, incorporates two separate sets of rules for limiting net operating loss carryovers.*/ First, the carryover of net operating losses will be denied if more than 50 percent of the loss corporation's stock changes ownership by purchase within two taxable years (i.e., there is insufficient "continuity of interest") and if the corporation does not carry on substantially the same trade or business both before and after the change in stock ownership (i.e., there is insufficient "continuity of business"). Second, the carryover of net operating losses will be limited if the shareholders of the "old" loss corporation acquire in certain types of nontaxable reorganizations less than 20 percent of the stock of the acquiring corporation as a result of their stock ownership in the loss corporation existing before the reorganization. In addition, net operating loss carryovers may be disallowed under section 269 if one corporation acquires at least 50 percent of the stock of another corporation for the principal purpose of securing the benefit of the carryovers.

We recognize that many corporate acquisitions can be structured to avoid the application of the section 382 limitations in situations where there is a bona fide business purpose for the acquisition. For example, if the acquiring stockholder plans to have the corporation conduct substantially the same trade or business after the stock acquisition, the acquisition could be structured as a simple stock purchase. By satisfying the continuity of business requirement, the loss corporation will be able to preserve the net operating loss carryovers even if 100 percent of the stock is purchased. Similarly, the net operating losses will be preserved in full if the stock of the loss corporation is exchanged for stock of an acquiring corporation in a transaction that qualifies as a nontaxable reorganization under either section 368(a)(1)(B) (in which case the rules of section 382 are expressly made inapplicable) or under section 368(a)(2)(D) (in which case it is likely that the requisite change in stock ownership would not be deemed to have occurred). Pre-acquisition net operating losses of a loss corporation could also be preserved if stock ownership was acquired through a combination of nontaxable reorganizations and purchases. Finally, the rules of section 382(a) could be avoided by structuring the acquisition as a series of purchases extending over a period of several taxable years.

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*/ Section 383 limits the use of various credits by a corporation if section 382 would be applicable to limit the carryover of any net operating losses. It is understood that H.R. 6295 would continue to rely on the section 382 rules for determining whether credits should be limited.

Despite the existance of these well-defined methods for avoiding the application of section 382, the lurking presence of section 269 has discouraged taxpayers from entering into transactions that consisted principally of a transfer of tax benefits.

In the Tax Reform Act of 1976, Congress made extensive changes to Section 382. In response to complaints that these amendments were unduly complex and burdensome, the effective date of these changes has been deferred repeatedly. As a consequence, the pre-1976 provisions of section 382 are scheduled to remain in effect until taxable years beginning no earlier than July 1, 1984.

The proposed revisions to section 382 contained in Section 301 of H.R. 6295 would implement many of the basic structural changes to section 382 contained in the 1976 Act amendments while eliminating much of the undue complexity. The most significant of the proposed changes would close the well-defined avenues for avoiding the limitations imposed under current law. First, the degree of change of stock ownership would become the sole test for determining whether, and to what extent, limitations on loss carryovers will be imposed; the change of business requirement would be eliminated from section 382(a). Second, the rules applicable to acquisitions in the form of nontaxable reorganizations would be amended so that the stock ownership of the shareholders of the old loss corporation in the surviving group of corporations would generally be the measure of continuity of interest. H.R. 6295 also contains detailed rules for implementing these basic structural changes.

Under these rules, no limitations would be imposed unless a 40-percent change in stock ownership had occurred; all loss carryovers would be eliminated if the change in stock ownership exceeded 80 percent.

In evaluating the proposed changes to section 382, at the outset two fundamental questions must be considered. First, should the ability to use net operating loss carryovers be determined solely by reference to the degree of continued stock ownership of the stockholders of the corporation that incurred the net operating losses? Although the Treasury Department recognizes that the answer is not entirely free from doubt, at this time we are not prepared to state that any single objective factor fairly measures the degree to which net operating loss carryovers should be preserved. We believe that it is necessary to explore alternative solutions to this problem before accepting a rule that may produce inappropriate results in certain situations. Second, in those situations where it is appropriate to impose limitations on the use of the carryovers, should the amount of losses to be carried to subsequent years be reduced directly? Again recognizing the difficulty of this question, the Treasury Department believes that imposing limitations based on the portion of income allocable to the continuing ownership of the shareholders of the loss corporation in the surviving corporate group should be examined to determine if it is preferable to limiting the losses to be carried to subsequent years.

1. Imposition of Limitations on Carryovers

In determining the circumstances in which the use of net operating loss carryovers should be restricted, it is important to consider the purpose for imposing limitations on the use of net operating loss carryovers. Originally, the ability to carryover net operating losses was intended as an averaging device (i.e., losses of a business in one year should be allowed to offset income of that business in a subsequent year). It is thus appropriate to limit the use of the carryovers to ensure that they are not applied against income earned by an entity unrelated to the entity that generated the unused losses. In devising these limitations, however, care must be taken to ensure that net operating losses resulting from such timing provisions as the accelerated cost recovery system are not routinely disallowed. Otherwise, income may be created as a result of the classic mismatching of income and deductions that the carryover rules are designed to eliminate.

We are not suggesting that the carryover rules should serve the function of providing unconditional Federal subsidies of corporate losses, a purpose for which they were never intended. Although we recognize that the unrestricted use of net operating loss carryovers may make risk taking in corporate form more attractive, it is not clear that such risk taking is relatively discouraged under existing tax rules. In addition, the unrestricted use of net operating loss carryovers would encourage the takeover of loss corporations by profitable corporations primarily to obtain the tax benefits of the loss carryovers. Such tax motivated mergers may have adverse economic consequences, and should not be encouraged. If it is desirable to subsidize corporate losses, there are more efficient ways to accomplish this than by encouraging noneconomic mergers. Indeed one of the purposes of the recently enacted safe harbor leasing provisions was to reduce the pressure to engage in such noneconomic activity.

Once it is accepted that limitations are appropriate, it is necessary to determine the circumstances in which the limitation should be imposed. Unfortunately, it is quite difficult to establish a simple objective test to determine when the connection between the entity that generated the losses and the entity that earned income is sufficiently tenuous to justify the imposition of limitations. However, it is generally agreed that the following three criteria are most relevant in making this determination: (1) continuity of ownership; (2) continuity of business; and (3) contribution to earnings.

While we believe that none of these criteria works perfectly in all situations, we recognize that each of these criteria could be relevant to a determination of when limitations should properly be imposed. At this time, we are not prepared to endorse the adoption of any single criterion as the sole factor to be used in determining whether to impose limitations.

H.R. 6295 relies upon continuity of interest as the sole touchstone for the application of section 382. Reliance on continuity of interest as a basis for limiting loss carryovers is supported by three factors. First, since 1954 Congress has treated continuity of interest as the sole factor justifying limitations on loss carryovers following most nontaxable reorganizations and as a significant factor following taxable stock purchases. Second, if continuity of interest were the sole relevant factor in all types of acquisitions, both buyers and sellers of a loss corporation would be able to determine, with much greater confidence than under current law, the extent to which carryovers would be limited following an acquisition. This would limit the ability of an acquiring corporation to realize a windfall. Third, relying upon a strict continuity of interest test would deter corporations from acquiring loss corporations to obtain the tax benefits of loss carryovers.

Although continuity of interest is a significant factor, we are concerned that reliance on continuity of interest as the sole basis for imposing limitations may frustrate the purpose of the net operating loss provisions as an averaging device. This problem arises when net operating losses result from a taxpayer's ability to deduct expenses prior to the year in which the corresponding items of income must be reported (the significance of which was reduced by the enactment of the safe harbor leasing rules presently in effect). If net operating loss carryovers resulting from the acceleration of deductions against an asset's income stream are limited where the trade or business that generated the losses is continued, a serious mismatching of income may result.

This mismatching is illustrated in the following example. Assume that a newly-formed corporation purchases equipment for $100 that will produce $10 of income every year for 20 years. Over the first 5 years the corporation will have, in aggregate, income of $50 and deductions of $100, leaving a net operating loss of $50. This net operating loss should be available to offset income generated in future years. Otherwise, the corporation will not have obtained the full benefit of its cost recovery deduction. If after 5 years the stock of the corporation is acquired in a nontaxable reorganization by a second corporation as a result of which the old shareholders of the loss corporation received less than 20 percent of the stock of the surviving corporation, the bill would eliminate the net operating loss carryover. Such a result prevents the averaging of the tax accounting losses incurred in the early years against the income of the latter years.

2. How to Limit Carryovers

If a sufficient change of stock ownership has occured between the year in which the net operating loss was incurred and the year to which the loss is to be carried, H.R. 6295 would limit the benefit of the carryovers by reducing the net operating loss that may be carried to all subsequent years. As we have previously illustrated, use of this loss limitation rule may prevent a business from obtaining the full benefit of its cost recovery deductions.

Under an income based method, the acquiring corporation would be able to carry the net operating losses in full to the post-acquisition years. However, the acquiring corporation would be able to apply the losses against only a limited percentage of its income for the year. The limited percentage would equal the percentage by which net operating losses would be reduced under rules analogous to those contained in H.R. 6295. In essence, the acquiring corporation would be treated as a joint venture of the loss corporation and the acquiring corporation. One income based method is described in a draft proposal prepared by the American Law Institute.

Under both limitations, a corporation would have much less of an incentive to acquire a loss corporation than exists under the current section 382 rules. In application, the principal difference between the two approaches would be that the extent to which the net operating losses may be used depends on the income allocable to the loss corporation; if the allocable share of income is very high, the full net operating loss carryover would be used very quickly; if the allocable share of income is low, then the net operating loss carryovers will be used more slowly than they would under the loss limitation rule, and may have less present value than the immediate utilization of a reduced carryover contemplated by the bill. Under the income limitation approach the acquiring corporation is more likely to be able to use the net operating loss carryovers generated by accelerated deductions against the income properly allocable thereto. For this reason, the income limitation rule deserves to be examined more closely to see if it represents a significant improvement over the loss limitation rule included in H.R. 6295.

3. Technical Provisions of H.R. 6295 Applicable to Loss Carryovers

Although the Treasury Department believes that more work is needed before a final resolution is reached on the issues raised by Section 301 of H.R. 6295, we would like to state our tentative views on certain provisions included in the bill as drafted. It should be recognized that our views on these technical provisions are made in the context of the approach to limitations incorporated in H.R. 6295. If a different approach to limitations is developed, certain of these views may have to be reconsidered.

A. Unified Treatment of Acquisitions by Purchase and Reorganization.

Under current law, changes in ownership resulting from purchases and from reorganizations are examined separately to determine whether there has been a sufficient change to justify the imposition of limitations on the use of net operating loss carryovers. Under these rules, different threshold percentage changes in ownership are required before the limitations would apply; for stock purchases, a 50-percent change in stock ownership is required; for reorganizations, an 80 percent change is necessary. H.R. 6295 would impose limitations if there has been a sufficient change of stock ownership whether the change results from purchases, reorganizations or a combination thereof. With respect to both stock purchases and reorganizations, no limitation would be imposed unless there were at least a 40-percent change in stock ownership; if there were an 80-percent change in stock ownership, the net operating loss carryovers would be disallowed in full. For each 1 percent change in stock ownership between 40 and 80 percent, the net operating loss carryovers would be reduced by 2 1/2 percent.

If continuity of interest is the sole factor, an integrated treatment of stock acquisitions by purchase and reorganization would seem to be appropriate in determining the extent to which continuity of interest exists. Under such a rule, the nature of the transactions that produced the changes in stock ownership should be, to the extent possible, immaterial.

Under H.R. 6295 the threshold percentage change in stock ownership of the loss corporation required to bring the limitation rules into effect will prevent the limitation rule from being triggered by insignificant changes in stock ownership. A collateral consequence of using such a threshold is that in certain circumstances an acquiring corporation will continue to have a small incentive to acquire a loss corporation. On balance, we believe that the small incentive that would remain is justified by the substantial administrative convenience for both taxpayers and the government that would result from the high threshold.

B. Composition of Test Group.

Current law examines changes in stock ownership attributable to taxable purchases by the 10 persons owning the largest interest in the corporation at the end of certain specified taxable years. H.R. 6295 changes the test group to include all shareholders. However, all shareholders owning less than a 5-percent interest in the corporation both during the loss year and the carryover year will be treated as a single shareholder. To illustrate, consider a loss corporation, 50 percent of the stock of which is owned by one shareholder with the remainder of the stock owned by numerous shareholders none of whom own more than 5 percent of the corporation's stock. No limitation on loss carryovers will be imposed if the small shareholders sell their stock to persons who do not acquire a 5-percent interest in the corporation. However, if all of the small shareholders sell their stock to a single purchaser, loss carryovers would be reduced by 25 percent (i.e., a 10 percent change in stock ownership in excess of the threshold multiplied by 2 1/2).

By examining the separate stock holdings of only those shareholders owning at least a 5 percent interest in the corporation, H.R. 6295 should significantly limit the recordkeeping requirements of most corporations and generally would make section 382 inapplicable to routine stock purchases of publicly held corporations. The Treasury Department agrees that the test group rules applicable to stock purchases set forth in H.R. 6295 are appropriate.

H.R. 6295 would calculate changes in stock ownership resulting from most reorganizations in a different manner, although the threshold test would remain the same. The continuing interest of the shareholders of the loss corporation would be the percentage of the stock of the surviving corporation acquired as a result of their preexisting stock ownership in the loss corporation. Changes in the relative ownership interest of individual owners would not be examined.

C. Duration of Test Period.

Under current law, net operating loss carryovers will be reduced as a result of stock purchases only if there is a sufficient change of stock ownership over a period of 2 consecutive taxable years. H.R. 6295 would compare stock ownership in the loss year and the year to which losses would be carried. By extending the test period, H.R. 6295 would require corporations to examine their stock ownership during each year to which net operating losses may be carried. We are concerned that this rule could impose an additional compliance burden on taxpayers. Our experience in administering other provisions that require computations of percentage stock ownership has led us to conclude that these provisions are complex and difficult to administer.

We recognize that the drafters of H.R. 6295 have included provisions that are designed to limit this additional burden. First, by treating all stockholders owning less than a 5-percent interest as a single group, the stock ownership of only a limited number of stockholders must be examined. Second, any change in proportionate ownership which is attributable to fluctuations in the relative fair market values of different classes of stock will not be taken into account. Given these moderating provisions, the additional compliance burden imposed by the extended test period may not be excessive. We would be pleased to work with the staff of the Subcommittee to establish additional rules to reduce this compliance burden.

D. Covered and Excluded Transactions.

Under current law, there are relatively few types of transactions other than reorganizations that would not be treated as a "purchase" for purposes of section 382(a). A "purchase" was defined in the Code as a transaction with an unrelated party in which the purchaser's basis in the stock is determined by reference to its cost. Thus, changes in stock ownership resulting from gifts, bequests, or exchanges that are not subject to tax in whole or part would not reduce the net operating loss carryovers. In addition, changes in stock ownership resulting from a reorganization described in section 368(a)(1)(B) or (E) are not subject to the limitation applicable to changes in stock ownership resulting from other reorganizations.

H.R. 6295 would expand the class of transactions subject to section 382. Only two types of stock acquisitions would be excluded from the application of this section. First, the current exemption for gifts and bequests would be retained. Second, stock acquired by a creditor who receives stock in certain bankruptcy, forclosure or similar court proceedings would not give rise to a limitation on net operating losses.

The Treasury Department believes that the exemptions of gifts and bequests from the application of section 382 are sensible and justified. Traditionally, transfers by gift or bequest have not been treated as significant events for most income tax purposes, and we believe that these types of transfers should not have income tax consequences for purposes of section 382. Stock acquired by a creditor in a bankruptcy reorganization is also excluded from the application of section 382. Since these creditors are likely to have borne a substantial portion of the economic loss that is reflected in the unused net operating losses, it may be appropriate to preserve the losses for their benefit. However, these creditors may have already received a tax benefit from their "investment" in the loss corporation by writing off their debts as bad debts. We are concerned that these creditors may receive excessive tax benefits if no limitation is imposed on the carryover of the losses.

In order to reduce the administrative burden of complying with these rules, we believe that it may be appropriate to exempt certain other classes of stock acquisitions from the application of section 382. We would be happy to work with you in determining the appropriate classes of exemptions.

4. Conclusion

The Treasury Department is concerned that the provisions of H.R. 6295 applicable to net operating loss carryovers could impose excessive limitations on the use of the loss carryovers in certain instances. We believe that further examination of this important area is necessary to determine whether limitations can be devised that would avoid some of the possible excesses that could result if H.R. 6295 were enacted.

"F" Reorganizations Involving Multiple Corporations.

Section 368(a)(1)(F) of the Code defines a reorganization (an "F" reorganization) as "a mere change in identify, form, or place of organization, however effected". In recent years, the courts have held that an F reorganization may involve the combination of mutiple operating companies. Indeed, in Home Construction Corporation of American v. United States, 439 F.2d 1165 (5th Cir. 1971), the court held that the amalgamation of 123 separate corporations qualified as an F reorganization.

A number of rules in the Internal Revenue Code, however, are premised on the assumption that an F reorganization may involve only a single entity. For example, section 381(b)(1) provides that the taxable year of a transferor corporation does not close in an F reorganization. Accordingly, if the component corporations in a multi-party F have different fiscal years, taxable years of greater than 12 months may be possible.

Section 302 of the bill would expressly limit F reorganizations to cases involving a single corporation. The Treasury Department supports these changes as a means of maintaining the integrity of these existing Code rules.

One important feature of this issue, however, involves the availability of net operating loss carrybacks. Section 381(b)(3) of the Code provides that, except in an F reorganization, post-reorganization losses of an acquiring corporation may not be carried back to a pre-reorganization year of a transferor corporation. In light of the fact that the proper treatment of net operating loss carryovers is to be considered carefully in the coming months, we believe that consideration should also be given to the treatment of net operating loss carrybacks in the overall scheme. Such overall consideration, we believe, can only lead to a well-reasoned treatment of this entire area.

Items for Future Consideration

Other problems in the corporate area have been identified which we believe warrant legislative consideration. Examples are situations involving the formation of holding companies and the interrelationship of sections 304 and 351 of the Code and the disparate definition of various forms of reorganizations under section 368.

We also suggest that consideration be given to remedying certain of the problems that have been encountered with respect to section 367. That section was designed to prevent tax avoidance resulting from transfers of property by or to foreign corporations.

The questionable judicial interpretation of section 367 in some of the recent cases has created considerable uncertainty as to the criteria to be considered in determining the existence of a tax avoidance purpose for a transfer. For this reason, we believe that legislation is necessary to clarify the scope of section 367. We suggest in this regard that an objective standard be adopted which would reflect the original intent behind that section.

We would be please to assist the Committee in exploring solutions to these problems.

APPENDIX

SUMMARY

H.R. 5719, would impose a 15-percent excise tax (50 percent where the acquiring entity is controlled by a foreign government) in certain corporate acquisitions. The Treasury Department opposes H.R. 5719.

H.R. 5517, would deny a deduction for interest on indebtedness incurred in connection with a corporate acquisition where the President determines that use or reservation of debt for such purposes should be discouraged. The Treasury Department opposes H.R. 5517.

H.R. 4562 and H.R. 5855, would deny all deductions for interest paid or incurred on any loan the proceeds of which are used in connection with an "unfriendly" takeover or attempted takeover of a corporation. The Treasury Department opposes H.R. 4562 and H.R. 5855.

H.R. 6295, would make several changes to the corporate tax provisions of subchapter C of the Code. The bill contains rules designed to make the tax laws neutral from the standpoint of the corporate seller as respects the disposition of certain assets directly or through a redemption of stock. H.R. 6295 also contains provisions designed to improve the principles of section 334(b)(2) of the Code, which treats certain stock purchases as asset acquisitions. Thirdly, the bill contains rules designed to limit the ability of an acquiring corporation to select for certain of the acquired assets a fair market value basis (with attendant cost recovery deductions) while preserving the acquired corporation's historic basis and other tax attributes for other assets. Fourth, H.R. 6295 provides rules to restrict an acquiring corporation's ability to utilize the loss and credit carryovers of an acquired corporation. Finally, the bill provides expressly that a reorganization described in section 368(a)(1)(F) can involve only a single corporation.

The Treasury Department strongly supports the neutrality approach of H.R. 6295 as well as the provisions designed to improve the operation of section 334(b)(2). The Treasury Department believes that further examination is necessary with respect to asset basis selectivity. We would pleased to work with the Subcommittee to reexamine the rules which deal with basis of assets acquired in intercorporate transactions.

With respect to loss and credit carryovers, the Treasury Department agrees that some limitation is appropriate. We believe, however, that further study is necessary to determine the proper form that limitation should take.

Finally, the Treasury Department agrees that an F reorganization should involve only a single corporation. We believe, however, that consideration of the appropriate treatment of net operating loss carrybacks should also be considered as part of the study of the treatment of loss carryovers.

Mr. HOLLAND. Mr. Glickman, Mr. Stark went over to vote, and he is going to return as soon as he votes. He has a number of questions that he wants to get into the record, so if we can stand in recess until he returns. We regret the inconvenience to you, but those things go off and we have to respond.

Thank you.

[Recess.]

Chairman STARK. It is the intention of the Chair to continue to work straight through. If this inconveniences someone in the schedule, we will put them on later in the proceedings.

I want to thank you, David, for your testimony and thorough consideration of the subject and the bills before us. I just have a couple of questions.

I am not sure if you are for us or against us or with us, but it is going to take me some time to digest your comments, as it is a complex topic.

In those areas where you felt you agreed with us, I think the section 311(d)(2) exceptions and partial liquidation areas, as well as a revision of 334(b)(2), those rules, do you think that some of these changes could be made by themselves and stand alone? Are there some areas you think need more study, some you oppose, some you agree with?

Do you see any objection to lifting out those areas which you support and doing those separately?

Mr. GLICKMAN. Well, the problem, Mr. Stark, with that approach is that there is so much interrelationship between a number of your areas.

If we were just talking about the neutralities, in other words, whether something is a sale of assets at the corporate level, the elimination of section 311(d)(2), has a great deal of merit to it. But the problem is that it interreacts with the selectivity issue in another context.

The real question that we ought to be facing here is whether we ought to do something that goes in the direction that solves the entire problem.

I do want to say this. From our view at this point in time, a lot of the problems in the selectivity area have been closed. However, our concern is that there still are some problems out there. Thus, the bottom line of the testimony was that we ought to go one way or the other.

We ought to either go to the repeal of General Utilities or we ought to then try to set up a very broad, all or nothing approach and let the chips fall where they may from there. That could reflect back on the 311(d)(2) issue and the 302(e) problem.

Chairman STARK. This is not an attempt at a pejorative statement, but it seems to me we are at a bit of the chicken or the egg impasse. You suggested that we study the net operating loss stuff, but the facts are that you all are jammed up with opinions so every time we worry about whether to raise revenue, you have to call people off in your department to work on new revenue statements.

Since 1976 we have put off changing the net operating loss limitations through one administration or another. We now are on hold through 1983. We have to get it done by then. I am not sure there is ever going to be a good time. From your standpoint of workload, from our standpoint and I guess at some point between this committee and your department, we are going to have to decide that the time is here.

I would think that we don't serve anybody by planning to just add another extension in 1983. I don't mean to use deadlines as a way to badger the department. Nor do I think that you are doing that to us. But if we could—and your testimony does not really address itself to this—establish some timetables in some areas, I have a hunch we would get it done. We always think if the end is in sight, as the sandwich board says, then we tend to get things done before the world's end.

I would hope that we could perhaps talk again after this hearing and decide on the order of priorities.

There is never enough time. I had hoped that you could help us separate out that which we could do independently. We must make some progress in this area because I think we owe it to the country at large, having brought the issue up, to see if we can't resolve some of it.

Mr. GLICKMAN. With respect to the 382 issue, Mr. Stark, as you know, there has been a great deal of work that has been done over the years although, as I understand it, the 1976 amendment came in without hearings.

Since that point in time, people have been studying this problem to a substantial degree. The American Law Institute has put in enumerable hours and obviously in our shop we spent time on it.

I think that the problem is that it is a very difficult problem to respond to because you have got to make some initial calls as to what type of limitations there should be.

Your bill has gone basically to a continuity of stock ownership cutback rule by eliminating the continuity of business requirement. The American Law Institute goes more to an income type of test.

In our shop, I am not sure how we come out right now, but I think that the income based concept of the American Law Institute has a lot to be said for it, and I think that we would be willing to certainly spend some time—and I am not talking about in the distant future, I am talking about in the near future—with your staff and try to figure out what direction we can all agree on.

Some of the people who are going to be testifying today are people who have spent untold hours in this area, and in that regard I think it is just going to come down to an issue of what type of restrictions ought to be enacted.

The other problems of the bill arise with respect to selectivity and neutrality. The problem there, as I said before, is I see a great deal of interrelationship. I think that even there decisions can be made, but those are hard decisions.

Chairman STARK. In alternatives, would you consider amendments to consolidate or return to regulations? Are there some things in the works in terms of regulatory changes that would make parts of this bill moot?

Mr. GLICKMAN. In my testimony I tried to be very nebulous on that. We obviously are familiar with some of the stated abuses in the area, and I have planned on having a regulations project open to take a look at some of these.

My reaction right now is that there are abuses out there. The failure to recapture the investment tax credit on a partial liquidation is troublesome. But as in other provisions, again, the abuse is in the eye of the beholder.

The fact that there is no recapture of depreciation on a partial liquidation occurs because the liquidation is considered to be a deferred intercompany transaction. That is what the consolidated return rules say, and there is at least some question as to whether that is appropriate.

Obviously your bill solves that problem to a large degree because it will require recognition of gain on partial liquidation as if the assets had been sold.

I think there is a lot of merit to that approach, and I think that a direction that we could see going in. I am going to open a project and see how many of these we can solve by regulations.

The problem is that like everything else, we have got a ton of regulation projects that we have not finished as it is.

Chairman STARK. Thank you.

The only thing I can say is, just as an observation from the Hill, there have always been a lot of problems—mostly political, I suppose—that you sense rumblings in the community and across the country. One of the things that I'm finding is the mounting pressure for a flat tax.

That is a political observation, not one of tax policy. Every time a discussion of a corporate or personal abuse comes up, the answer is just to shake your head and ask, "Why can't we pay a flat tax?"

The point is that as people get more disgusted with our system, we will get in worse trouble. I pass that along, and I appreciate your testimony. The record will stay open. The other Members and some staff may have specific questions that they would like to address to you in writing. We would appreciate it very much if you could respond to them.

Mr. GLICKMAN. May I make one more observation?

Chairman STARK. Yes, sir.

Mr. GLICKMAN. I would be concerned if our testimony was read in any other light than we were trying to point out the problems that we saw with the direction your bill was going. That does not mean that we think that the law just ought to be left as it is. I think that something ought to be done in this area because I personally believe that the people who know how to play the system are the ones that get the most benefit out of it. The lawyers in the smaller towns that don't practice as much in this area and their clients are the ones that have a great deal of detriment.

I think coming up with a very simple system in this area is very desirable and I believe that either end of the spectrum, the two possibilities which I mentioned, either repeal of General Utilities or the all-or-nothing approach, does set in place to some degree a much simpler process. I would hope that you would not take my testimony to say that I don't believe we should move forward.

Chairman STARK. I assure you that I take your testimony as very constructive and helpful. That is, I hope, the whole thrust of these hearings.

It is clear that there is some need. I'm sure that our staff and the staff of the Joint Committee will get to know each other a lot better over the summer since we are anticipating doing a lot of work on this. I appreciate your approaching it with both constructive and helpful criticism along with willingness to continue along that line.

Mr. GLICKMAN. And I'll commit that we will spend the time and energy to work through this with you.

Chairman STARK. I appreciate that very much. Thank you.

We have a panel now of Dr. William McElroy, a professor of economics of Georgetown University, and Prof. Martin Ginsburg, of Georgetown University Law Center.

Welcome.

Mr. MCELROY. Thank you, Mr. Chairman.

Chairman STARK. Dr. McElroy and Professor Ginsburg, we have your prepared testimony which will appear in its entirety in the record.

If you would summarize for us and highlight it, the Chair and the other witnesses I know would appreciate it. We also appreciate your taking the time to prepare this testimony but, as I am sure you are aware, it is going to take all of us a long time to absorb this.

Dr. McElroy, if you want to proceed first.

STATEMENT OF F. WILLIAM McELROY, PROFESSOR OF ECONOMICS, GEORGETOWN UNIVERSITY

Mr. MCELROY. Thank you.

In discussing these bills, I should make clear at the outset that I use the term "merger" to include any arrangement putting previously separately controlled assets under common control.

I would like to have been able to say that I had consulted an economic model showing exactly what would happen to mergers and tax revenues if these bills were passed. However, I have been unable to find sufficient data on the extent to which past mergers have involved arrangements which would be affected by the specific provisions of this bill.

This has forced me to look at more general tax provisions directed at merger.

Even at this broader level, estimation of the effects on merger activity is far from straightforward. To paraphrase Justice McKenna, it could be said that of course tax provisions affect merger activity, but they are only one among other influences and do not, more than the others, register themselves in clear and legible effect.

In spite of these difficulties, a number of scholars have attempted to isolate and measure the impact of tax provisions on merger activity. The results of these studies are discussed in an appendix to my testimony.

The picture which emerges from them is that specific merger related tax provisions probably have relatively modest effects on the overall level of merger activity. Consistent with this in a broad way is the fact that you have very large swings in the number of mergers even though the tax provisions relating to mergers have stayed the same or nearly the same.

For example, in the early seventies, the number of merger and acquisition announcements was running around the 5,000 level. At the end of the seventies, that was down to around 2,000.

This is, of course, not to deny that taxes are a relevant consideration in any merger, nor is it to claim that merger-related tax provisions have not been critical in some instances. Rather, the implication of the studies is that the great bulk of mergers which occurred would have done so with or without these provisions—although the latter undoubtedly influenced the prices paid in virtually all mergers.

Finally, it should be pointed out that the above conclusion relates to directly merger-related tax provisions. It does not address the impacts of the many provisions such as deductibility of interest on debt, relatively light taxation of capital gains, et cetera, which have indirect effects on the desirability of mergers.

These indirect effects, which can be quite substantial, are also discussed in an appendix. The conclusion of the analysis in that appendix is that the present tax system on balance provides significant incentives for firms to diversify, particularly via merger.

Thus, I concur with the unstated premise of the goal of H.R. 6295, namely, that the present tax system is not neutral toward mergers.

Because, for reasons explained again in detail in an appendix, I believe that firm diversification produces many social benefits and that mergers are often an appropriate means of diversification, I'm not wholly in agreement with the idea that the tax system should create neither special benefits from nor impediments to mergers.

For example, it does not trouble me that the tax system might provide some modest net incentives to diversification. However, I see no reason why Federal policy should particularly favor mergers over internal means of diversification. Accordingly, I support the goal of H.R. 6295 to make the tax system more nearly neutral to mergers.

I believe that if the bill is passed, the tax system will still be on balance providing incentives for mergers as, of course, does the present relaxation in antitrust enforcement.

I am not suggesting that the bill would not deter any mergers, although I do believe the mergers so deterred are less likely to have relatively large nontax benefits associated with them. It is necessary to be wary of the proposition that since the bill would only remove certain tax advantages any merger with positive benefits exclusive of these tax advantages should still be attractive.

The fact is that the after-tax rate of return to such merger investments will be lower, though still positive, and this will certainly lead to some prospective mergers failing to pass required rate of return hurdles in the capital budgeting processes of corporations.

Indeed, the general level of search activity to locate prospective merger partners could be expected to be reduced somewhat. It obviously remains true that the mergers most likely to be scuttled because of the bill are those for which a relatively large proportion of the benefits would have come from the existence of the specific provisions that would be altered.

This result is hardly a social loss to the extent that these provisions in any case allow violation of the canons of sound tax policy such as substance rather than form should determine taxability.

Furthermore, since the studies discussed above suggest that all of the merger related tax provisions taken together have not had major impact on the level of merger activity, it would be surprising if the subset of provisions altered by H.R. 6295 had more than a minor impact on the level of mergers.

This, of course, makes the bill more attractive as a revenue raising measure. Because of the continuing strong upward trend in merger activity—that is we started in 1981 on an upward swing and it has gone on in the first quarter of 1982—the extra taxes collected on the large volume of mergers expected to be consummated even if the bill is passed could be significant.

Moving on to another topic of the bill, I would like to talk about the current recession's effects on the importance of the loss-carryover provisions. That is certainly going to be heightened by the recent increase to 15 years in the carryover period as well as by the investment incentives in the 1981 act. The latter will, of course, produce situations in which quite healthy companies show losses for tax purposes.

Since my expertise in the complexities of the tax code is extremely limited, I cannot claim to understand exactly what the loss-carryover provisions of H.R. 6295 would accomplish, but I would hope that any provisions in this area would not tend to encourage the unnatural continuation of assets in relatively unproductive uses.

As to the other bills which have been proposed, I strongly disagree with their approach. First, even if one dislikes certain mergers, penalizing debt financing of them seems an ineffective means. For one reason, all corporate sources and uses of funds are so highly substitutable for each other that it is virtually impossible to say what a given dollar of debt or of equity actually is used for.

Second, I do not consider the general antimerger tone of some of the bills as healthy. If properly policed by antitrust, mergers can serve overwhelmingly benign purposes such as moving assets to higher-valued uses and allowing diversification. The extreme case is the use of a hostile takeover to remove incompetent management and it would be particularly unwise to inhibit this process.

Opponents of mergers also frequently argue that financing them diverts funds from more productive investments. This seems to me quite specious, since for one thing, stock-for-stock mergers need not involve any other funds. More importantly, I believe that effective management will evaluate mergers by the same criteria by which they will evaluate other investments, and only if the merger seems a more productive use of assets will they engage in it.

It is, of course, other things being equal, more desirable that firms would diversify by entering new lines or expanding existing capacity, rather than by acquiring other firms' assets. But this is not always optimal.

For example, when the industry has excess capacity it is more desirable that a firm enter by acquiring some of that. Similarly, when the industry's capacity is just adequate but a particular firm is not well-managed, it is desirable that a more competent firm diversify into this industry by acquiring those assets. In these cases, it would be poor policy to inhibit acquisition by penalizing debt financing.

In conclusion, I am in favor of the approach of H.R. 6295, which I believe to be designed not so much to inhibit mergers but to prevent revenue losses which arise due to the present code allowing certain ingeniously structured transactions to escape the taxes payable by economically equivalent mergers which are less artfully crafted.

Thank you.

[The prepared statement follows:]

STATEMENT OF F. WILLIAM MCELROY

Mr. Chairman and members of the subcommittee, my name is William McElroy. I am a Professor of Economics at Georgetown University. Among the courses I teach are Industrial Organization and Economic Regulation and Antitrust.

In discussing these bills I should make clear at the outset that I use the term merger to include any arrangement putting previously separately controlled assets under common control.

I would have liked to be able to say that I had consulted an economic model showing exactly what would happen to mergers and tax revenues if these bills were passed. However, I have been unable to find sufficient data on the extent to which past mergers have involved arrangements which would be affected by the specific provisions of these bills. This has forced me to look at more general tax provisions directed at mergers. Even at this broader level, estimation of effects on merger activity is far from straightforward. To paraphrase Justice McKenna (speaking in 1920 on the effects of competition on prices) it could be said that, of course, tax provisions affect merger activity, but they are only one among many factors and do not, more than the others, register themselves in clear and legible effect. In spite of these difficulties, a number of scholars have attempted to isolate and measure the impact of tax provisions on merger activity. The results of these studies are discussed in Appendix 1.

The picture which emerges from them is that specific merger-related tax provisions have probably had relatively modest effect on the overall level of merger activity. This is, of course, not to deny that taxes are a relevant consideration in any merger. Nor is it claimed that merger-related tax provisions have not been critical in some instances. Rather, the implication of the studies is that the great bulk of the mergers which occurred would have done so with or without those tax provisions—although the latter undoubtedly influenced the prices paid in virtually all mergers.

Finally, it should be pointed out that the above conclusion relates to directly merger-related tax provisions. It does not address the impact of the many provisions such as deductibility of interest on debt, relatively light taxation of capital gains, etc. which have indirect effects on the desirability of mergers. These indirect effects which can be quite substantial are discussed in Appendix 2. The conclusion of the analysis there is that the present tax system, on balance, provides significant incentives for firms to diversify, particularly via merger. Thus, I concur with the unstated premise of the goal of H.R. 6295, namely that the present tax system is not neutral toward mergers.

Because (for reasons explained in detail in Appendix 3) I believe that firm diversification produces many social benefits, and that mergers are often an appropriate means of diversification, I am not wholly in agreement with the idea that the tax system should create neither special benefits from, nor impediments to, mergers.

It does not trouble me that the tax system provides some net incentives to firm diversification. However, I see no reason why federal policy should particularly favor mergers over internal means of diversification. Accordingly, I support the goal of H.R. 6295 to make the tax system more nearly neutral to mergers.

I believe that, if the bill is passed, the tax system will still, on balance, system provide incentives for mergers—as does the presnt relaxation in antitrust enforcement.

I am not suggesting that the bill would not deter any mergers, although I do believe the mergers so deterred are less likely to have relatively large non-tax benefits associated with them. It is necessary to be wary of the proposition that, since the bill would only remove certain tax advantages, any merger with positive benefits exclusive of these tax advantages should still be attractive. The fact that the after-tax advantages should still be attractive. The fact that the after-tax rate or return to such merger investments will be lower (although still positive) would certainly be expected to cause some prospective mergers to fail to pass required rate of return hurdles. Indeed, the general level of search activity to locate prospective merger partners could be expected to be somewhat reduced. It obviously remains true that the mergers most likely to be scuttled because of the bill are those for which a relatively large proportion of the benefits would have come from the existence of the specific provisions that would be altered. This result is hardly a social loss to the extent that these provisions in any case allow violation of canons of sound tax policy, such as that substance rather than form should determine taxability.

Furthermore, since the studies discussed above suggest that all of the merger-related tax provisions taken together have not had major impact on the level of merger activity, it would be surprising if the subset of provisions altered by H.R. 6295 had more than a minor impact on the level of mergers.

This, of course, makes that bill more attractive as a revenue-raising measure. Because of the continuing strong upward trend in merger activity, documented in Appendix 4, the extra taxes collected on the large volume of mergers expected to be consummated even if the bill is passed, could be significant.

Apart from the current recession's effects, the importance of the bill's loss carryover provisions is certainly heightened by the recent increase to fifteen years of the carryover period, as well as by the investment incentives in the 1981 Act. The latter will, of course, produce situations where quite healthy companies show losses for tax purposes.

Since my expertise in the complexities of the tax code is extremely limited, I cannot claim to understand exactly what the loss carryover provisions of H.R. 6295 would accomplish. I would hope that any provisions in this area would not tend to encourage the unnatural continuation of assets in relatively unproductive uses.

As to the other bills which have been proposed I strongly disagree with their approach. Firstly, even if one dislikes certain mergers, penalizing debt financing of them seems an ineffective means. This is because all corporate sources and uses of funds are so highly substitutable for each other, that it is virtually impossible to say what a given dollar of debt (or equity) actually is used for.

Secondly, I do not consider the general antimerger tone of some of the bills as healthy. If properly policed by antitrust, mergers serve overwhelmingly benign purposes such as moving assets to higher-valued uses and allowing diversification. The extreme case is the use of a hostile takeover to remove incompetent management, and it would be particularly unwise to inhibit this salutary process. Opponents of mergers also frequently argue that financing them diverts funds from more productive investments. This seems to me quite specious since, for one thing, stock for stock mergers need involve no funds of other kinds. More importantly, effective management will evaluate merger by the same criteria as alternative uses of funds and engage in a merger only if that is likely to be more productive than alternative investments. In the same way, although it is more desirable, in terms of employment and competition, that firms diversify by entering new lines or by expanding existing capacity, rather than by acquiring other firms' assets, this is not always optimal. For example, when the industry has excess capacity, it is more desirable that a firm enter by acquiring some of it. Similarly, when the industry's capacity is just adequate but a particular firm is not well managed, it is desirable that a more competent firm diversify into this industry by acquiring these assets. In these cases, it would be poor policy to inhibit acquisitions by penalizing debt financing.

In conclusion, I am in favor of the approach of H.R. 6295 which I believe to be designed not so much to inhibit mergers, but to prevent revenue losses which arise due to the present code allowing certain ingeniously-structured mergers to escape the taxes payable by economically equivalent mergers which are less artfully crafted.

Thank you.

APPENDIX 1.—STUDIES OF THE IMPACT OF MERGER-RELATED TAX PROVISIONS

Three recent studies sponsored by the Federal Trade Commission are relevant.

Boucher (3, pp. 36, 38, 79, 126, 141, 143, 152), in interviews with executives, found that taking advantage of tax provisions ranked twentieth (out of twenty five) in importance as a merger motive. Carleton et al (4, p. 50 ff) find no significant evidence that a large loss carryover makes a company more likely to be acquired. Feld (6, pp. 52, 64, 66) concludes that merger-related tax provisions have had only marginal significance in motivating mergers. Another recent study whose findings suggest a relatively small causative rule for tax provisions is that of Mueller (9, pp. 286 ff).

These recent results are broadly consistent with earlier findings of Steiner (14, pp. 206–7) that tax options were probably rarely of critical importance in motivating mergers. These last two studies were primarily concerned with explaining the wave of mergers which reached a peak in the late 1960s. Scherer (12, p. 128) also provides data relevant to the possible effects of loss carryovers in this merger wave. In the 1966–1969 merger boom only twenty four out of the five hundred and fifteen manufacturing and mining corporations (with assets of ten million or more) which were acquired reported net losses in the year before their acquisition. However, in the generally less prosperous 1970–1975 period, when overall mergers of this size totalled only three hundred and eighty three, forty seven acquired companies had prior-year losses. In addition, very few of the acquiring companies in either of these periods had losses.

APPENDIX 2.—INDIRECT INCENTIVES TO DIVERSIFICATION AND MERGER CONTAINED IN THE TAX CODE

Apart from the tax benefits of provisions dealing directly with the tax treatment of mergers, there are many provisions of the overall tax code which help diversified companies. Amongst the most obvious are the consolidated return provisions, and the generally greater flexibility of the diversified firm in using deductions, credits and carryover items. Less obvious are the effects of tax deductibility of corporate interest payments. Here, as pointed out by Sherman (13), the advantage stems from the fact that a diversified firm having less risky earnings will be able to have a larger proportion of debt in its capital structure. Also, the taxation of dividends and interest received at higher rates than capital gains, gives the diversified company a particular advantage since it can internally reallocate funds from lower yielding to higher yielding uses without shareholders being taxed—as they would be if a dividend were paid by one firm and used for reinvestment in another.

Inheritance tax provisions also create numerous advantages from merger arrangements. These are examined by Lackman (7).

APPENDIX 3.—SOCIAL ADVANTAGES OF FIRM DIVERSIFICATION

There are four main social advantages connected with firm diversification.

1. It permits realization of so-called economies of scope which arise when it is cheaper to have firms produce several products simultaneously than to have specialist firms produce them individually. Scherer (12, ch. 4)

2. Because divisions of diversified firms typically have to compete with each other for use of corporate investment funds, the projects in which they invest tend to have higher rates of return than are realized in undiversified firms. This is borne out most recently by Ravenscraft (10). See also Rumelt (11).

3. Intelligent diversification serves to reduce the risk of bankruptcy as well as the fluctuations on earnings. Although investors can diversify their own portfolios, various capital market features make it more efficient for firms to do it for them. See Monroe (8), Amihud and Lev (1), and Benston (2).

4. Diversification may offer employees better prospects of employment stability because of the fact that some product lines are often expanding in volume while others contract.

There are some possible disadvantages to diversification, as discussed in Dean (5). I am not convinced that these come close to outweighing the advantages. For instance, the issue of the effects of diversification, and particularly diversification by conglomerate merger, on competition has been vigorously debated. See Scherer (12), Benston (2), Wiggins (15). In my view, the conclusion produced by this debate is that there has not been much evidence of the feared evils (reciprocity, deep-pocket predatory cross-subsidization, etc.) which conglomeration has been accused of spawning. On the positive side, allowing firms to diversify either internally or through toehold acquistions, would seem to be a potentially powerful procompetitive policy. Further, it seems axiomatic that discouraging diversification will tend to encourage firms to channel their expansionary efforts towards strengthening their positions in domestic markets where they already may have strong positions. Alternatively they may direct their expansionary efforts to diversification abroad—with possible consequences for losses in domestic jobs.

By all this I do not mean to suggest that conglomerate mergers are some sort of panacea. Peter Drucker, in a recent Forbes interview, estimated that only one merger in five is truly successful, with two out of five being near disasters. While this may overstate the case, the recent high level of spinoff activity is broadly consistent with it. Again, however, discouraging of corporate diversification via conglomerate merger would retard the undoing of mistakes, or efficient adjustment to changed conditions.

APPENDIX 4.—RECENT TRENDS IN MERGER ACTIVITY

As can be seen from Table 1, the number of merger announcements in 1981 was the highest since 1974. Not shown in the table is the $82.6 billion record value of mergers in 1981, which almost doubled the previous record of $44.3 billion set in 1980. According to Mergers & Acquisitions, activity continued strong in the first quarter of 1982, with a total value of $23.5 billion being recorded.

TABLE 1.—NET MERGER AND ACQUISITION ANNOUNCEMENTS, 1969–81

	Number	Change [1]
Year:		
1969	6107	+37
1970	5152	−16
1971	4608	−11
1972	4801	+4
1973	4040	−16
1974	2861	−29
1975	2297	−20
1976	2276	−1
1977	2224	−2
1978	2106	−5
1979	2128	+1
1980	1889	−11
1981	2395	+27

[1] Reflects percentage change year to year.

Source: W. T. Grimm & Co.

Table 2 shows recent trends in the number of tender offers since 1975. Comparison of the numbers in it with those of Table 1 shows the relative infrequency of this approach to merger. However, the last year saw a marked increase in this activity, and, because of the large dollar volumes involved in some of the recent offers, tenders account for a much larger share of dollar volume than their numbers would suggest.

Table 2.—Tender offers for publicly traded companies 1975–81

Year:	*Total Announced*
1975	58
1976	70
1977	60
1978	90
1979	106
1980	53
1981	75

Source: W. T. Grimm & Co.

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Chairman STARK. Thank you very much, Dr. McElroy.

You mentioned something that caught my attention. That is that management and I'm going to presume here we are speaking of professional management in major corporations. I wonder if there is not a substantial change there in incentive.

There is usually very little correlation between the long-range benefit of shareholders and the relatively short-range benefit of chief executive officers.

I wonder if economists and those who study management might not see that we have different incentives. In fact in mergers the interests of professional managers often have relatively short tenures, 5 years in one place and 3 years in another. It is totally unrelated to the productivity of the enterprise or the profitability of the shareholders. I am not sure that we can always count on that most of the incentives are wrong.

Managers may gain some short-run incentive by beefing up current earnings per share, witness some of the airlines that may have an overabundance of debt that are going bankrupt around us. Probably history will show that it was pretty poor management decisions to take a very small engine and put a big fuselage around it. It is probably more for the sake of the aggrandisement of a chief executive operating people than for the long-range benefit of the shareholders. That is a guess.

I am not pointing at any particular airline; I do not know how that relates to the tax code, but I was struck by your feeling that we can depend on management to do the economically sound thing. I also question whether we do not have a new variable in that program that was not there 5 or 10 years ago.

Mr. MCELROY. I would certainly never assume that management was interested in anything except for their own interests, but the same would be true of shareholders or anyone else, and I think to the extent that the compensation systems of management do involve the shares of stock of the company, this is certainly a widespread protection of some sort. I am not saying it is always effective, but I think, for that very reason, it is important to preserve methods of the corporation going to better management which will think more of the shareholders interests, and I also think that, again, diversification on the whole is something that does tend to reduce the risk of bankruptcy if properly undertaken. And these are reasons to be careful in inhibiting particular types of mergers.

Chairman STARK. Professor Ginsburg, your statement will appear. Would you like to summarize it or expand upon it for us?

STATEMENT OF MARTIN D. GINSBURG, PROFESSOR OF LAW, GEORGETOWN UNIVERSITY LAW CENTER

Mr. GINSBURG. Thank you, Mr. Chairman.

Having submitted a written statement of some length, in my oral testimony, in accordance with your instruction, I shall attempt to be mercifully short.

Over the past dozen or so years it has been my privilege to testify before this subcommittee mainly on one common theme, the need to rationalize and simplify our inordinately complex tax law. I will do it again today.

Having burdened the subcommittee with that long written statement, I should like to speak this morning in aid of just a few notions. The first of them is that there really are serious probelms out there and they really do deserve serious attention.

The root of a large class of these problems is that a basic, if incomplete equation in our tax system has broken down. Congress has designated various recapture toll charges to be paid at the time the bases of certain assets are stepped up to reflect purchase price. Clever tax lawyers have found wonderfully Byzantine ways to obtain the step up but defer or eliminate altogether the toll charge. Large amounts are at issue. Congress really ought to take a hand in the game and the bill provides an important beginning.

The second notion I should like to put is that the current rules governing taxable corporate acquisitions are equally defective on the other end. Mr. Glickman touched on this very important point at the close of his colloquy with the chairman. While the wealthy and well-advised achieve all sort of undue, unintended and truly wonderous advantage, under the current rules smaller corporations and their owners, lacking access to the most sophisticated and costly tax advice represented by good lawyers and good accountants who simply are not experts in the arcane mysteries of subchapter C and the consolidated return regulations are grossly disadvantaged.

Not merely that they do not do as inappropriately well as the big folk. Rather, because they are at serious risk of being trapped into tax disaster because the current system is so extraordinarily complex and discordant.

Three years ago this subcommittee heard exactly these things, undue advantage to the wealthy and well advised, undue burden on the less affluent said of another set of tax rules that affect sale transactions.

I refer to the 1979 hearing on the legislation that became the Installment Sales Revision Act of 1980. Then using related party sale and resale techniques, the well-to-do were disposing of property, receiving immediate cash within the family group, and deferring tax for decades. Muddling along as best they could, average people were incurring immediate tax liability but not receiving the cash for years or even decades.

The bill initially introduced in 1979 focused on the undue advantage proposing a cure much more intrusive than the problem really required, and failed to focus adequately on many of the no less important problems of unintended disadvantage that plagued less sophisticated taxpayers.

In the legislative process, however, Congress wisely chose to deal with the variety of installment sales problems as what they in truth were, facets of an integrated complexity, and detailed the legislation to meet rather than overwhelm the problems that first attracted congressional intention. In so doing, Congress produced truly simplifying, rationalizing, effective, and rightly applauded tax legislation. And so the third notion I should like to put is that we are in quite the same situation as regards the bill now before the subcommittee.

There are significant abuses that merit a swift cure. The bill approaches them in a way which condemns through greatly increased taxation selective asset basis step-up, but does not alter the tax burden when step-up affects all the historic assets of the target corporate group.

In this the bill I believe, hits some cases too hard, hits other cases not nearly hard enough, and for the reasons I have attempted to explore in my written statement, probably will not work very well in practice. The difficulty, I think, is that the focus is in part in the wrong place.

Selectivity, which is the bill's apparent main concern, is not, I believe, the central issue. The central issue is the threshold nonrecognition rule, the so-called general utilities doctrine, and it is that mischievous doctrine the bill ought to address directly and, I believe, restrict in a uniform way.

In this I find myself largely in the same way as the Treasury Department. I suppose my one difference with the Treasury Department, based upon Mr. Glickman's testimony this morning, is that I find it difficult to believe that if we take a different approach, a piecemeal approach, it really is possible to turn off the tax bar. The tax bar is the repository of the greatest ingenuity in America, and given the chance, those people will do you in.

On the other side, the bill does not attempt to deal directly with the unintended hardships that now are visited on less sophisticated taxpayers, although certain of the bill's proposals, notably the very sensible elective step-up concept of new section 338, easily could be refined to accomplish major simplification for the benefit of smaller taxpayers, small business, and the taxing system as a whole.

Mr. Chairman, in introducing, H.R. 6295, you have done the tax law a very great service. I hope the committee, the congressional staffs, the Treasury and the private bar will go forward to develop the bill into a conceptually unified, broad-based harmonization and simplification of the tax rules that currently govern purchases and sales of corporate business. The effort is long overdue.

[The prepared statement follows:]

STATEMENT OF MARTIN D. GINSBURG

Mr. Chairman and members of the subcommittee, my name is Martin D. Ginsburg. I am a professor of law at Georgetown University Law Center where I teach various subjects in the field of federal taxation. For some twenty years prior to becoming an academic, and with a more modest time commitment since, I have practiced law primarily in the federal tax field.

Over the past dozen or so years it has been my privilege to testify before the Ways and Means Committee, the subcommittee, and your Senate counterparts in aid of a common theme: The need to rationalize and simplify our inordinately complex tax law. While on many of those occasions I was identified with bar association tax groups, I hasten to note that these groups have not had an opportunity to react fully to the legislation now before this subcommittee and I appear today only in individual capacity.

In introducing H.R. 6295, the Chairman has done the tax law an important service. The main focus of the bill is the taxable acquisition by one corporation—for convenience I will refer to it as P corporation—or corporate group of part or all of the stock or assets of another corporation—I will call it T or Target corporation—or corporate group. The current tax treatment of many of these transactions is, to put it simply, wildly unsatisfactory. The issues are important and, in concentrating the attention of the Treasury Department, the private sector, and the Congress on some of these issues, the bill is equally important.

The apparent genesis of H.R. 6295, apparent from the nature of the changes it proposes in present law, are some rather well publicized recent corporate acquisitions in which the tax treatment sought, and in a number of cases clearly obtained, by the purchasing P corporation group seems excessively favorable, far beyond what a rational Congress could have anticipated or in fact did anticipate. I readily admit to sharing that view.

The bill proposes to deal with its chosen abuses in a heavy way. The common denominator among most of the chosen is selective electivity, a picking and choosing by P corporation which assets of the Target corporation or a target corporation subsidiary are to be awarded a stepped-up basis, employing a current tax law technique that will or at least may defer or avoid entirely the tax costs—depreciation recapture, investment credit recapture, and other immediate income or gain recognitions—that Congress in an earlier and less tax sophisticated time thought it had imposed. The bill addresses selective electivity offering, on the face of it, a rather unpalatable choice: Either no step-up in the basis of any of the assets selected, or corporate-level recognition of the total gain, above and beyond recapturable depreciation and the like, inherent in the assets selected. But, because H.R. 6295 would not impose an equivalent recognition regime in the absence of the particular kinds of selectivity the bill indentifies, it does not and realistically cannot address its concerns in a simple, rational, and effective way. The bill is an important starting point but it is not, I believe, a satisfactory place at which to end.

Let me attempt to examine H.R. 6295 from the general viewpoint of sensible tax revision.

Due in part, I think, to the highly commended enactment of The Installment Sales Revision Act of 1980 and the extended and careful legislative process that attended the formulation and passage of that legislation, there is today a fairly accurate perception of how segments of our tax law fall into misfortune and how resurrection may be accomplished. Over time Congress enacts and occasionally amends what it designs to be sensible tax legislation. Over time the Treasury Department promulgates what it intends as sensible regulations. And over time the Internal Revenue Service adopts administrative and litigation positions it believes sensible or required or both. Usually if not invariably, each actor is rational at the inception, rational in terms of what is known and what reasonably can be anticipated at the inception.

But inevitably events overtake and things change. As time goes on, previously unperceived traps open for the unwary. Previoulsy unperceived but no less marvelous opportunities of tax avoidance are uncovered, special benefits to be availed of, more often than not, through the employment of wonderfully Byzantine tax planning. In the end we seem to arrive at the same unhappy place. Less affluent taxpayers, represented by decent lawyers and decent accountants who are not great tax experts, are unfairly disadvantaged. Affluent taxpayers, able to obtain and afford the most sophisticated tax advice, gain undue and unintended advantage.

In design and in practice, we have a transactional tax law. To eliminate unintended hardship as well as unintended advantage, to rationalize the tax law and simplify it in practice, the objective should be the awarding of economically equivalent tax treatment to transactions which, if facially distinguishable, at bottom are not different in any way that tax policy need or ought regard. To achieve that highly desirable state of affairs, it is not fruitful to focus on an abuse or two here, a misfortune or two there, important as each may be. Rather, it is essential at the threshold to identify the dominant tax policies the statute was intended to requite, and the ways in which and reasons why the evolved statutory and regulatory scheme has produced discontinuities in tax treatment inconsistent with or at the least not man-dated by those underlying policies. It is only consequent upon these initial determinations that a coherent revision of the taxing scheme effectively can be undertaken.

The difficulty with H.R. 6295, I think, it that it has short circuited the process. The Bill primarily reacts to a few specific, perceived abuses under current law. But, because it does not proceed from a re-examination of underlying policies and an identification of the basic generators of inappropriate differentials in current tax treatment, the Bill fails to address some important issues, touches other more or less incidentally, and handles still others in ways that are at the least questionable and in the long run likely to prove ineffective and unworkable. In this I do not denigrate the drafters. They have approached the assigned task with a clear awareness of what the accomplishing of it must entail, specifically the need to back-stop the proposed rules relating to a corporate stock acquisition with more rules covering contributions, distributions, and asset acquisition transactions. That some of these back-stopping rules may not work very well, or indeed in some cases may not work at all, essentially is not the fault of the drafters. It is, rather, that they have been assigned a thankless task.

The main policies that underlie our tax treatment of taxable corporate acquisitions are not obscure.

First, we have a clear commitment to electivity. If P purchases the stock of T and holds T as a subsidiary, the historic basis of the T assets is preserved and no "recapture" tax is triggered at the corporate level. On the other hand, if P wishes to obtain the T assets at a basis stepped-up to reflect purchase price, P is free to elect that result. P may do so by purchasing the assets of T in which event "recapture" is on the T side, or P may purchase the T stock and then liquidate T in a manner comporting with present section 334(B)(2). In the latter case "recapture" again is in T but P, as owner of the T stock, will have a direct interest in the recapture tax cost and, sensibly, P will have factored that burden into the purchase price equation.

Second, when asset basis is stepped-up incident to a corporate acquisition in which the shareholders of T recognize gain or loss, we do not normally extract at the corporate level tax measured by the full appreciation in the value of all of the target corporation's assets. Congress historically has been unwilling to impose, under our system of separate corporate and shareholder taxation, full tax at both levels. As the statutory law has evolved, Congress has chosen to impose full tax at the shareholder level when corporate stock or assets are purchased, but under sections 336 and 337—the Code's embodiment, along with section 311(a), of the so-called General Utilities doctrine—Congress has chosen to eliminate corporate level tax on capital and some ordinary gains. Over the past twenty years, however, the legislative direction has been toward including more ordinary income in the liquidating corporation's tax base.

Third, because sections 336 and 337 contemplate transactions in which P acquires the T assets at a stepped-up basis, the T shareholders receive long-term capital gain, and only limited corporate tax is imposed on T incident to the disposition of its assets, the opportunity of excessive tax avoidance is presented when T is used by its shareholders as a vehicle to transmute into long-term capital gain that which, had the shareholders operated outside corporate solution, would have been ordinary income to them. Section 341, the collapsible corporation provisions, was initiated by Congress to curb this abuse. Under the present system section 341, or something like it, is both necessary and the ultimate embodiment of complexity in the Internal Revenue Code. It works poorly for a variety of reasons, not the least of which is the inability of revenue agents and almost everyone else to understand it.

Fourth, selective electivity, in particular the ability to treat differently the divisions or subsidiaries of the target corporation, also has long been an embedded notion of our taxing system. But, unlike the Congressional directed rules relating to electivity that govern when T operates a single business and has no subsidiaries, the rules of selective electivity in significant part have evolved through administrative pronouncement and court decision. It is hardly surprising, therefore, that the tax law in this area exhibits no unifying principle, fails to reflect a sensible policy directive, and is frankly chaotic.

Congress has not been entirely out of the picture, of course. In enacting section 337(c)(3), Congress facilitated sale of the assets of Target corporation's subsidiary while leaving untouched Target's historic permission to sell instead the stock of its subsidiary. In this Congress recognized, perhaps implicitly but nonetheless appropriately, that selectivity should not be a concern when it is the seller's selection that is in view. Certainly if Target corporation is a holding company with two subsidiaries and, in its liquidation, Target sells the stock of one subsidiary to one purchaser, the assets of the second subsidiary to another purchaser, underlying policy does not urge that this transaction be burdened with some special additional tax. On the other side, Congress has instructed us that the nonrecognition benefits of section 337 are not to be available at the corporate level if the assets of only one division are sold and the proceeds distributed in partial liquidation; limiting tax on the corporation's sale requires full recognition of gain at the shareholder level. On the other hand, and in my view wrongly, under current section 346(a)(2) much corporate level gain may be avoided if the assets of the division first are distributed to the shareholders who thereafter ever-so-carefully sell those assets to a buyer waiting in the wings. If tax rationality and simplification lie in treating equivalent transactions equivalently, Congress in this regard has done nothing for the cause.

But some of the major problems, including specifically some of the problems the Bill seeks to address, are not the creatures of Congress. In large part they were spawned by the consolidated return regulations and certain of them, at least, could be resolved by the Treasury Department without legislative impetus. Resolution of others will benefit from Congressional assistance.

The dominant themes of H.R. 6295 are approval of complete electivity—either preservation of basis or step-up of basis of all of the assets of T and its subsidiaries—and condemnation of selective electivity when selection is on the buyer's side. The techniques proposed to implement that condemnation are varied, but the message is clear: The General Utilities doctrine is preserved in a complete step-up transaction, repealed when the buyer picks and chooses.

I find two essential difficulties with the approach of the Bill. One is conceptual, the other practical.

As a conceptual matter, it seems to me questionable whether, in widening the corporate-level recognition gap that already exists in the Code, between "complete" and "partial" step-up acquisition arrangements, we move in the right direction.

The problem under current law, at bottom, is that using sophisticated planning taxpayers can achieve a better result—a heightened application of the General Utilities doctrine—through selective electivity that would obtain had section 336 and either section 337 or section 334(b)(2), the complete election provisions, been employed. If we are going to address the General Utilities doctrine, as certainly I believe it time we do, would it not make more sense to address that doctrine directly? Is it not more sensible to eliminate the present recognition gap rather than to widen it? When the basis of an asset is stepped-up incident to a corporate acquisition, should we not seek to extract the same recognition toll charge, with respect to the appreciation in that asset, whether the election is complete or selective? Ought we not undertake the threshold task of re-examining the General Utilities doctrine to determine whether, in every case, the recognition toll charge should be imposed on more—on, for example, all ordinary income items and on capital gain property held less than a specified number of years—than sections 336 and 337 now require? Should we not then bend our efforts to assuring that the toll charge will be promptly payable whether the transaction giving rise to the impost on the affected assets involves a complete election, a selective election, a straightforward acquisition, or a truly Byzantine transaction?

My practical concern with the Bill's approach is a simple one. I do not believe it accomplishes the intended result as the legislation is drafted, and if we maintain and indeed widen the recognition gap between elective transactions designated complete and elective transactions designated selective, I strongly doubt it is possible to craft legislation that cannot be subverted. The ingenuity of the tax bar is legion. When the stakes are sufficiently high and the statutory scheme attempts to draw a bright line, highly sophisticated tax practitioners will seek ways to cross, tunnel under, or walk around that line. Nearly seventy years of tax history assures us that sooner or later, and probably sooner, they will succeed.

In sum, for reasons both conceptual and practical, while agreeing fully with the Bill's informing notion that under current law substantial tax is inappropriately avoided and a congressional directive much needed, I think the approach taken in H.R. 6295 misdirected. I believe Congress should design uniform recognition rules, not disparate rules, under which the scope of the General Utilities doctrine is restricted uniformly.

With this in mind, let me turn finally to the Bill's main provisions.

The Bill proposes to repeal paragraphs (A), (B), (C), and (G) of section 311(d)(2). This seems to me entirely sensible. By definition T is a continuing corporation. The arguments that can and have been made in favor of eliminating corporate level capital gain tax when all of the assets or stock of T are acquired by a third party are not relevant.

The Bill proposes to eliminate the corporate mechanic of a section 334(b)(2) liquidation, when the controlling stock of T has been recently purchased by another corporation, and to substitute a simple election. Pursuant to that election, T will be treated as having sold all of its assets to an unrelated corporation in a transaction governed by section 337. Setting aside for the moment the selective electivity issue, I believe the proposed change will yield major benefits in tax simplification and tax rationality, and I endorse it strongly.

The proposal seeks to place all corporate acquisitions under a uniform taxing regime. Section 337, which now governs only the asset sale transaction, will govern the stock acquisition as well. The benefit to taxpayers and the taxing system will be enormous in eliminating the many and varied discontinuities that currently inhere in the tax treatment under section 337 and the tax treatment under section 334(b)(2). While there are, I believe, a number of technical matters to be worked out through further drafting, the direction taken in the Bill is inevitably sound and simplifying.

I would, however, point to a few of the problems focused by the Bill in its present form.

It is wholly unclear why the Bill limits the benefits of the new election system to transactions in which the controlling stock of T has been purchased by a single corporation. Why should not this benefit be available when the purchase is made by two or more corporations that are members of an affiliated group? More significantly, why should not this benefit be available if within a twelve month period control of T has been purchased by a partnership or a trust or an individual or a group of individuals or, most simply, by a variety of folk? The elective system is highly salutary in eliminating the requirement that what is simply a tax election be made through a corporate mechanic. Why is it not equally sensible, and more consistent with the Bill's general approach, to allow the election to be made whenever control is purchased and thereby avoid forcing the buyers to organize a corporation solely to effect the purchase, file the election, and then either liquidate or merge downstream into the Target corporation?

If P purchases only 90 percent of the stock of T, the remaining 10 percent standing in the hands of unrelated Mrs. K, and the step-up election then is made, the Bill would award the T assets a basis equal to P's basis in its T shares plus, apparently, the liabilities of T including, one hopes, the taxes imposed on T by reason of the step-up basis election. This seems to me a wrong answer. Sensibly, asset basis should be stepped-up to reach what would have been the result had P also purchased the T shares owned by Mrs. K at the equivalent price, and tax should be levied inside T in an amount appropriate to the full step-up in asset basis. If Congress should determine that the full "recapture" tax is an insufficient recompense for the full asset basis step-up the Bill should be further amended to provide that section 337 will not apply to the percentage of T's realized gain that reflects the shares owned by Mrs. K. Appropriately, the Bill might further provide that, if within some specified time following the date of election, P purchases shares owned by Mrs. K, the additional tax levied on T will be appropriately adjusted or refunded.

If P purchases one-half the T shares on January 1, 1983 and the other half on July 1, 1983, under the Bill it is not entirely clear by what date P must file the step-up election and as of what date that election is effective with respect to T. In the described case, I would recommend that the last filing date be specified as two-and-a-half months (rather than 60 days) after July 1, the date on which P has acquired control of T. More important, I believe the election should be effective as of the opening of business on July 1, and that with respect to the consequent gain recognition "old" T, to which gain will be recognized, should be treated as a separate corporation that is not a member of any affiliated group of corporations that includes P. Two highly desirable tax results should flow from these rules. First, if P is part of an affiliated group of corporations filing a consolidated return and possessed of a consolidated net operating loss or loss carryforward, that loss will not offset the gains recognized by T incident to the election. Thus, the overall tax consequences will be the same whether P purchases the stock of T or P or a subsidiary of P purchases the assets of T incident to T's section 337 liquidation in favor of its historic shareholders. Second, by triggering the T gains at the inception we can avoid maintaining in the tax law any of the complex and unsatisfactory basis adjustment rules now found in the regulations under section 334(b)(2). This alone must be accounted a major blow for tax simplification.

The Bill proposes to revise section 337, applicable to a sale of assets and liquidation of the Target corporation, apparently for the sole purpose of protecting the Bill's condemnatory approach to selective electivity. While I believe section 337 should be revised as part of an overall rethinking of the General Utilities doctrine, for the reasons indicated earlier I would not change section 337 in the manner contemplated by the Bill. Surely there is no reason to penalize T or its historic shareholders if in liquidation T sells the assets of one subsidiary to one buyer, the stock of another subsidiary to an unrelated buyer. And there is no logical reason to penalize T, when sales are to P alone, in a world in which selectivity produces, with respect to the assets of the subsidiary or division chosen, no untoward benefit of tax deferral or tax elimination.

The Bill contains special rules under which increased tax is attracted, when asset basis is stepped-up, if the Target corporation earlier engaged in one or another distribution or contribution transaction. Again, these rules are designed to protect the Bill's condemnatory approach to selective electivity and, again, a uniformly restricted application of the General Utilities doctrine will eliminate the reason for rules of this sort.

Proposed new section 346, a basket "toll charge" provision, is largely a horse of the same color. It is, however, especially significant in recognizing that provisions of the consolidated return regulations often supersede provisions of subchapter C, and in declaring that hereafter this will not be so with respect to "recapture" toll charges. The declaration is important and welcome because under present law a partial liquidation by one member of the affiliated group in favor of another, particularly when the controlling stock of the distributor is newly purchased, will yield a step-up in the basis of the assets transferred at no immediate "recapture" tax cost. In this the consolidated return regulations operate in a manner inconsistent with underlying tax policy. Sensible revision of those regulations, as they apply in corporate stock acquisitions, is long overdue. I would only add that while the Bill is salutary in flagging the problem, the forced recognition solution it espouses is at least debatable. A different approach, one that would better comport with a more uniformly applicable statutory scheme, would hold that distribution within an affiliated group will not produce a change in asset basis and thus will not trigger "recapture" gain. Under this approach selective electivity and consequent gain recognition would be permitted only within the framework of an election under a form of new section 338 revised to authorize selective electivity.

That comment in part exposes my view of the Bill's proposed elimination of current section 346, the partial liquidation provision. H.R. 6295 would continue to award shareholder capital gain treatment on the distribution of the assets or the proceeds of sale of a qualifying trade or business, in effect preserving current section 346(b) in a now mandatory form while eliminating the "corporate contraction" aspect of current section 346(a)(2), but would render inapplicable to the approved asset distribution the corporate level nonrecognition benefits of section 336. That the Bill on its face also appears to eliminate section 346(a)(1) presumably qualifies as an oversight. The proposed treatment of "corporate contraction" distributions seems to me entirely sensible. As stated before, I would apply uniform recognition rules at the corporate level if shareholders receiving the assets of a qualifying trade or business are to be awarded capital gain treatment. But I would urge the latter notion be given further thought. Certainly there is an argument, and perhaps a better one if new section 338 is revised to authorize selective electivity, that a partial liquidation distribution is really a glorified taxable dividend and ought to be treated that way.

Apart from the asset basis and recognition provisions that make up the bulk of the Bill, H.R. 6295 also proposes yet another version of section 382 and a "single corporation" limiting clarification of section 368(a)(1)(F). I would comment on these only briefly.

As to section 382, the text of the new proposal, in light of the history of past provisions in force and in suspension, suggests further thinking at the threshold would be appropriate. All of the legislative versions now extant approach the loss corporation problem in terms of limiting the available carryover. The Federal Income Tax Project (subchapter C) of the American Law Institute, on the other hand, after extended study has suggested a quite different approach, the imposition of a limitation on the income against which the loss may be applied in any year. Strong conceptual arguments support that proposal. Without question, there are problems of complexity inherent in the ALI proposal that merit further study. But this hardly qualifies as a condemnation for, again without question, there are practical problems of complexity in any statute designed to limit the transferability of tax loss benefits.

As to the proposed revision of section 368(a)(1)(F), it seems to me long overdue. The change might, however, profitably be accompanied by a re-examination of the present rules governing loss carrybacks.

Mr. Chairman, the tax rules governing taxable corporate acquisitions are, I think it fair to say, a mess, and H.R. 6295 performs great service in forcing a reconsideration of them. The Bill's objectives are sound in attempting to limit tax considerations as the motivating factor in taxable corporate acquisitions. The legitimately debatable question is whether the Bill pursues its objectives in the most effective way.

For the reasons stated, I think it does not. But I believe the Bill provides Congress an opportunity, a starting place from which to develop, I would hope with the strong cooperation of the Treasury Department and the institutional tax fraternity, more pervasive legislation that will achieve the major objectives and will do so in a way that harmonizes this area of tax law and greatly simplifies it in practice.

In a remarkable way the present posture of things is reminiscent of the 1980 installment sales legislation. The bills introduced in 1979 responded to significant tax abuse and to a few special problems of practical disharmony, but did not attempt to deal with the area in a rounded way. Hearings promptly exposed the wider issues, the great need to rationalize and simplify the rules, and another approach to the focused tax avoidance concern, one designed to cure the abuse in a less Draconian way. The congressional committees embraced the opportunity and, after much careful collegial work and furhter hearings, the process brought forth genuinely effective, simplifying tax legislation.

I believe the introduction of H.R. 6295 offers a similar opportunity to rationalize and simplify the tax treatment of taxable corporate acquisitions. I sincerely hope Congress will grasp it.

Thank you.

Chairman STARK. Thank you very much.

Secretary Glickman talked about repealing the *General Utilities* decision. Would you see that as a realistic option?

Mr. GINSBURG. Put in those terms, I would say it would be a millennial event and we have not quite reached the millennium.

Chairman STARK. The Congress does not do anything millennial in even-numbered years.

Mr. GINSBURG. I think in this particular case it would not be vastly different if it were an odd numbered year, but I do not think the matter need be approached in that draconian way. We have a situation under the *General Utilities* rule where, if a corporation sells its assets and liquidates, or distributes its assets in liquidation, or does a variety of other things, we tax, or we try to tax, at the corporate level certain recapture income and a miscellany of items. But, for example, we do not currently tax the profits built into ordinary income assets, inventory stock in trade, and so forth. That has never seemed to me to make a great deal of sense.

We have recently seen Congress having difficulty with the question of LIFO inventory versus FIFO inventory. I would think a much more sensible approach would be to treat both the same way, and tax the profits at the corporate level on all of these ordinary income assets.

I think that it would be fruitful to focus on whether some of the other business and investment assets that have been held less than some specified period of years might, when distributed, also be taxed at the corporate level. That, however, is a far cry from saying that we will tax everything in-house, and then have to go to a general integration rule to blunt the excessive double-tax burden.

Chairman STARK. I appreciate both of you gentlemen taking the time to testify, and I look forward to studying your testimony in detail later. Thank you, Professor Ginsburg and Dr. McElroy.

Our next witness is Mr. James Dertouzos, an economist, and Kenneth Thorpe, who I presume is an intellectual from the Rand Graduate Institute. The Rand Corp., is from the great State of California, I presume.

We have your prepared testimony. It will appear in its entirety in the record. You may proceed jointly if you like. Please summarize and share the chores of testifying, as you see fit. Proceed.

STATEMENTS OF JAMES DERTOUZOS, ECONOMIST, AND KENNETH THORPE, RAND GRADUATE INSTITUTE, THE RAND CORP.

Mr. DERTOUZOS. Thank you. This afternoon what we want to do is simply and very briefly present some key findings from a research project conducted by Rand on behalf of the Small Business Administration over the last year and a half, I suppose.

The views and conclusions that we express today are our own, and don't reflect those of Rand or the Small Business Administration, and the topic of this research project involved the economic incentives behind the merger activity that we have observed in the daily newspaper industry in the last century.

This particular study is of interest to the subcommittee for a variety of reasons. Most importantly, we believe that as a case study, the merger activity and the economic incentives for those mergers are likely to be very much reflective of merger activity in general.

The focus on a particular industry enabled us to abstract from many of the the eocnomic incentives which could in essence affect the merger incentives in general, and to the extent that we have been able to identify those incentives, we believe that the importance of tax law as an additional incentive is better identified than in previous work.

As you probably know, the daily newspaper industry has been undergoing some very dramatic changes in this century. Early in the century virtually all daily newspapers were independently owned, private family owned, closely held corporations.

Currently, about 70 percent of all those daily newspapers are owned by larger conglomerates. The activity continues, and the phenomenon that we observe is larger chains buying up smaller chains, and this is of importance for a variety of reasons which go far beyond the interest in merger movement in general, but there are several first amendment issues that are of concern, and several issues with respect to the viability of a small family-owned enterprise in an economy which is pretty much dominated by larger corporations.

What we attempted to do was identify all the economic incentives that we could, and examine them very carefully to ascertain to what extent Government regulations and tax law play a role.

I am going to defer to my colleague to discuss some of our conclusions with respect to the pure economic efficiency incentives, and then I am going to return to some of the tax incentives.

Chairman STARK. If I could just interrupt there, it would occur to me that the newspaper business is probably one of the very least regulated businesses in the whole world. Outside of the tax code, offhand, I can't think of any regulations.

Mr. DERTOUZOS. There are good constitutional reasons for that, of course.

Chairman STARK. But isn't that correct?

Mr. DERTOUZOS. That is correct.

Chairman STARK. Really, if you want to look at that——

Mr. **Dertouzos**. There are special laws, of course, which exempt the newspaper industry from certain types of proceedings that no other industry is exempt from, antitrust, for example.

Chairman **Stark**. But in the negative sense of regulation in terms of impinging on the independence of an operation of a business, I think you would be hard pressed to find one less regulated.

Mr. **Dertouzos**. You probably couldn't.

Chairman **Stark**. Go ahead.

Mr. **Thorpe**. I would also like to thank you, Mr. Chairman, for allowing us the opportunity to testify here today. I think the biggest contribution that our research could make is, first of all, to ask a question, really to ascertain the possible effectiveness that your proposals will have on mergers, and in order for us to do that, you first of all have to assess somehow the relative effectiveness or the relative role that tax incentives and economic incentives assume in merger activity.

What we did then basically is conduct an empirical study to determine what role economic incentives assumed in merger activity in the newspaper industry, and I will just briefly summarize our findings there. Basically, we had three possible or three major categories in which economic incentives could be born out in almost any industry. The first area we looked at is just something which economists like to label the pecuniary advantages, and that is just that larger firms are able to obtain inputs at a cheaper cost, and by inputs I am talking about what they pay for labor and what they also pay for any capital equipment.

In the newspaper industry, we specifically looked at the prices paid for newsprint in wage rates by chain newspapers compared to independent newspapers. The basic conclusions we found that on average the chain-owned newpapers didn't pay any different prices than independently owned papers, the hypothesis being really if there are any economic advantages with regard to chain ownership you would suspect perhaps the chains could pay less. We didn't find any differences.

The second major category that we were interested in was just looking at what sort of cost benefits there were to being a chain member. Economists also have another name for this, and they like to call that economies of scale.

For example, group-owned papers could be more efficient or have lower costs than independent papers, for a variety of reasons. Groups can produce news and information centrally, advertising centrally and distribute it to member newspapers at virtually low marginal costs.

Second, it is often said that larger firms have some sort of management economies; that is, they can attract better managers, they can have troubleshooters that they can send from member newspaper to member newspaper to iron out various wrinkles.

What we did in this regard was to develop a model of newspaper firms to ascertin whether on average group-owned newspapers had lower marginal costs of operation than independently owned newspapers, and again our conclusion was consistent. We didn't find any differences, just by the sake of being a group-owned paper.

The third area that we are interested in then that could possibly explain the mergers that we had seen in the industry was that chain-owned papers adopt to changing technology faster. The newspaper industry in the last 10 years has undergone a rapid change in technology. Indeed, the whole nature of the newspaper plant has changed in the past 10 years.

In this area what we did is we looked at the relative speed by which chains and independently owned newspapers adopted technology. Through a variety of models by which we estimated, we didn't find any difference by chain ownership. We found chain ownership and independent newspapers on average adopted technology with very similar speeds.

Basically, the conclusion on this side of the study was that none of the traditional economic incentives that we could find really explain the merger activity in the industry. The conclusion then being was that the mergers that were seen couldn't really be explained by economic incentives, and the second part of our study then dealt with the relative role that tax incentives assumed in the merger activity, and for that Jim is going to go into it.

Mr. DERTOUZOS. The upshot of all that analysis is that most of the traditional explanations which you find in economics literature and in the literaure with respect to the particular industry turn out not to be important in explaining the merger movement. Chains do not appear to operate any differently.

The individual newspapers to a large extent are autonomous. This makes a lot of sense, given the existence of external market forces which provide the same services that a chain would internally provide, the wire services, sellers of new technology have a very great incentive to supply all of the information necessary, and all the software necessary to sell their equipment. So it turns out—and our conclusions empirically are very, very robust—it turns out that these independent newspapers are really run no less efficiently than those owned by the large chains.

So that leads us to the inevitable question: Why have all these mergers occurred? and leads us to another empirical phenomenon which is very interesting, and that is that the prices at which these firms are being purchased seem to far exceed any reasonable valuation of present value of the profits of those firms that the chains would even reasonably expect to earn. So we went into a detailed examination of the various tax laws. I needn't go into the tax law incentives, because they turn out to be very similar to those found elsewhere.

Of particular interest in the newspaper industry is the accumulated earnings penalty. It seems that the particular case law for the industry enables a large chain, that may have upwards of $500 million in retained earnings, can avoid that tax on that accumulated earnings amount simply by supposedly actively engaging in the search for another newspaper.

If you occasionaly purchase a newspaper with assets of $1 or $2 million, you are able to avoid the penalty on an amount which exceeds that by as much as 500 times. So in particular that aspect of the tax law seems to be a particularly strong incentive in the newspaper industry.

The laws with respect to loss carried forward, the investment tax credit, the wedge between capital gains and personal income tax, all these also create an incentive, and would give a manager of a large firm the incentive to pay a price which exceeds the present value of the profits of the acquired firm, and still make it, in a profit maximizing sense, a very rational decision.

In addition, estate taxes play a very large role in the industry. Many of the firms being sold are subject to a very large estate tax, and it turns out that IRS regulation procedures, which value the firm at its selling price rather than its value as a going concern, and since that value, that selling price value is inflated due to these tax advantages, it turns out that valuation far exceeds the ability of the current owners to pay, and so it is sort of a two-fold exercise in which the incentive to buy create an incentive to sell.

We went about the business of trying to empirically estimate the importance of all these tax laws in dollar terms, and our conclusion was that out of approximately every $1 spent in acquiring a firm, about 25 percent of that involved pure tax advantage, and we have to emphasize that those conclusions are based on a residual analysis, that is, we are assuming that the wedge between what the firm is worth in an economic sense and what price is actually paid, we are assuming that that residual is equivalent to the tax. But given the robustness of our studies with respect to economic efficiencies, there is absolutely no reason to believe the chains are actually improving the performance of these firms, and we feel fairly strongly that, indeed, that a wedge is a pure tax phenomenon.

[The prepared statement follows:]

Economic Incentives To Merge

(By James N. Dertouzos and Kenneth E. Thorpe, the Rand Corporation)

INTRODUCTION

We are going to present the key findings of research conducted by the Rand Corporation on behalf of the Small Business Administration. The views and conclusions expressed are our own and should not be interpreted as representing those of Rand or the Small Business Administration.

The ownership structure of the daily newspaper industry has been undergoing some rather dramatic changes during the twentieth century. The industry was once dominated by small, family-owned enterprises. In 1910, for example, there existed only 13 companies owning more than a single newspaper firm. Thus, only three percent of all U.S. daily newspapers were members of chains. Today, about 70 percent of all establishments are subsidiaries of larger corporations. Our research project examined the economic causes of this newspaper conglomeration.

Merger activity can be the consequence of a variety of economic phenomena. For example, there may exist multi-firm economies of scale. A newspaper chain might be more efficient and be able to produce at lower per unit costs. Also, big firms may enjoy pecuniary advantages. That is, newspaper firms may obtain inputs at lower prices. In addition, the industry has undergone a technological revolution. Group membership could facilitate adaptation to rapid changes in technology. Finally, tax incentives to both buy and sell can play important roles in merger activity. The research provided an empirical examination of each of thee potential motives to merge.

ECONOMIES OF SCALE

If groups are more efficient than independent newspapers, the merger activity may be due to economies of scale. Cost savings can stem from a variety of sources. Perhaps groups can produce news, features, and advertising centrally and distribute content at low marginal costs to member newspapers. Also, there may be economies of scale in management. For instance, chains generally maintain a squad of trouble shooter specialists who contribute expertise to member newspapers that may be week in marketing, distribution, or production.

However, despite these conventional wisdoms concerning the economic advantages of chains, there are reasons to doubt their importance to the changing structure of the industry. Most significantly, external markets have evolved to provide services which are internal to large groups. For example, national advertising agencies can minimize transactions costs for independent newspapers. The development of the wire services and feature syndicates provides sufficient volumes of centrally produced material for independent firms.

To test this proposition, a model of the daily newspaper was developed and estimated using data from a mail survey of firms. Under the standard assumption that firms maximize profits, it was possible to compare implied marginal costs of production for independents with group newspapers. The empirical results were not ambiguous. For the production of circulation, advertising space, and news content, group newspapers did not exhibit marginal costs which were significantly lower. There was no evidence for multi-plant economies of scale.

It is possible that the results are biased by misspecification of the model or the underlying behavioral assumption of profit maximization. Further work in this area is desirable. However, the econometric results are robust and consistent with past research as well as the conventional wisdoms concerning the newspaper industry. Thus, it seems doubtful that the evolving ownership structure of the newspaper industry is due to economies of scale.

PECUNIARY ECONOMIES

An empirical examination of newspaper input prices was undertaken to test the proposition that groups enjoy financial advantages. For example, chain newspapers might realize savings by purchasing newsprint in bulk. Also, groups could be better equipped to deal with labor unions. If this is true, wage expenditures will be lower for chain newspapers.

Data on newsprint prices and wages for several categories of labor were utilized in an empirical study. The evidence suggested that group affiliation does not confer any pecuniary advantages to member newspapers. Newsprint prices facing individual firms appear to be determined in national markets. Firm specific characteristics proved to be useless in explaining the variation in the average price of newsprint consumed during the 1979 fiscal year. The empirical description of wage differentials resulted in the same conclusion. Wages do not systematically vary by ownership characteristics. All things equal, group newspapers pay the same prices for inputs. Thus, pecuniary economies can not explain the wave for merger activity.

TECHNOLOGICAL DIFFUSION IN THE NEWSPAPER INDUSTRY

The past decade had been marked by an electronic revolution in the newspaper industry. Indeed, every facet of newspaper production has been affected by the increased utilization of new computer technologies. For a variety of reasons, large firms may be better suited to technological change. To begin with, big corporations may have capital market advantages that are realized via better access to financial markets or because internal distributions of capital are more efficient. In addition, newspaper chains can sequentially adopted new technology in separate establishments thereby minimizing risk, developing transferable computer software, and benefiting from a "learning curve."

These potential advantages are the basis of some of the more convincing arguments suggesting that the growth in newspaper chains stems from existence of economic efficiencies. If the cost of adoption of the new technology for a newspaper is lower for a chain member, mergers will be encouraged. The same conclusion holds if the benefits of computerization are higher for chains due to facilitated interfirm transfers of features, news, or advertising content.

However, equipment suppliers and manufacturers have incentives to provide software in the marketing of new technologies. Also, the transfer of new technology has been facilitated by extremely active trade associations. These associations support research laboratories, hold conventions and exhibitions, and disseminate information to members. For these reasons, the supposed technological advantages enjoyed by chain newspapers are likely to be minimized.

Two models of technological diffusion were developed and estimated. The evidence suggests that the size of the individual newspaper is positively correlated with the rate of diffusion. However, there exists a size threshold beyond which size is no longer a factor. On the other hand, group newspapers have not, in general, adopted at a faster pace. There is some evidence that small, regional groups began utilizing certain technologies earlier. However, large groups exhibit no apparent advantage.

Thus, the growth in newspaper chains can not be explained in terms of more efficient adaptation to technological change.

TAX INCENTIVES AND NEWSPAPER MERGERS

Economists have long recognized the importance of tax laws in encouraging mergers. Tax laws can create incentives to sell as well as to buy. First, current estate rules can make it impossible for heirs to retain ownership of the newspaper firm. The high marginal tax rates in combination with IRS valuation methods based on newspaper firm transaction prices result in annual estate tax liabilities which exceed operating income. In addition, tax laws create incentives to acquire firms. These stem from a variety of tax policies. For example, the wedge between capital gains and personal income tax rates motivates mergers if a subsequent stock appreciation converts potential dividend earnings into asset value growth. The case law on accumulated earnings also creates motives for merger. Corporations can avoid a substantial tax surcharge on excess accumulated earnings by making merger acquisitions. Finally, laws regarding loss carry forward provisions, treatment of depreciation, and tax-free stock exchanges can all create incentives to merge.

In order to measure the potential magnitude of the tax motivation, a model was developed and applied to newspaper transactions occurring since 1972. To quantify the potential impact of tax regulations, it was assumed that firms will pay a price which is equivalent to the present value of the expected stream of future profits associated with the acquistion. Estimates of the magnitude of the incentives suggest that the acquiring firm can save at least 25 cents in taxes for each dollar expended.

Unfortunately, estimates of the magnitude of the tax parameters are highly sensitive with respect to the assumptions of the estimating model. In particular, the discount rate employed in the analysis is subject to considerable uncertainty. A more direct test of the tax incentives is desirable and should have highest priority in future research. However, the estimates are intuitively plausible and the qualitative conclusions are defensible. That is, the tax laws create economic incentives for merger that are likely to be quite large. Although the Economic Recovery Act of 1981 will diminish the incentives to some extent, tax law will continue to promote merger activity.

CONCLUSIONS AND POLICY RECOMMENDATIONS

The research conducted suggests that the increased importance of newspaper chains is not the result of efficiency gains due to conglomeration. The consistent absence of evidence that group ownership matters is quite convincing. There are no measurable advantages in input markets, multifirm scale economies, or differences in the rate of technological diffusion. For the most part, independent firms are indistinguishable from newspapers that are subsidiaries of larger corporations. In addition, groups do not significantly alter the performance of the newspapers they purchase.

These conclusions do warrant further investigation. In particular, systematic deviations from the presumption of profit maximizing behavior on the part of newspaper managers could alter the results. Also, a better characterization of the process of technological diffusion within newspaper groups is desirable. Finally, the recent release of 1980 Census data permits a more detailed and reliable description of the local newspaper markets. Thus, the more precise identification of several factors which influence the demand for newspaper products can be made. Of special interest are the roles of market demographics, regional, characteristics, and the nature of media competition.

However, these extensions would, in all likelihood, not alter the conclusions. The empirical results were extremely robust and quite insensitive to alternative specifications of the underlying models. In addition, they are consistent with several institutional factors as well as previous research in this area.

On the other hand, tax laws can provide strong economic incentives for merger. In the absence of alternative economic motivations, we are left with the implication that tax laws are a primary cause of mergers in the newspaper industry. The generalization of this result to other industries should have the highest priority in future research.

These results have important policy implications. Surely, a democratic society depends on a diverse forum for the creation, assimilation, and dissemination of ideas and information. Corporate acquisitions of daily newspapers, as well as weeklyes and cable television franchises continue. To the extent that such merger activity is encouraged by tax laws which appear to have little or no economic justification, government agencies with the appropriate jurisdiction should consider remedial policies. On the other hand, the absence of evidence that group newspapers, on average, operate in a manner which is measurably different from independents can be given a positive interpretation. That is, the existence of several group newspapers, none of which dominates a large percentage of U.S. circulation, does not yet have very important ramifications.

More importantly, our analysis of newspaper groups does have more general policy implications. The tax benefits identified are likely to be a primary motivation in the merger activity occurring elsewhere. If these policies were meant to stimulate the types of investment which add to the economy's real stock of capital but instead simply encourage transfers of property, they need to be reevaluated. The following changes should be considered.

1. Estate taxes can force heirs to relinquish properties. Although recent changes in the tax rates and terms of payment should alleviate the problem, heirs will, in usual circumstances, be unable to pay taxes out of current earnings. Perhaps IRS estate tax valuations should be based on the probable income of the ongoing business, not market value.

2. Provisions for the assessment of excess accumulated earnings penalties might be revised. First, accumulations for future estate taxes could be allowed. Secondly, the standards for accumulations for "reasonable business" needs can create a distortion. The lenient case law in the case of newspaper groups which occasionally purchase other properties might be made more stringent. In addition, the requirement that firms grow only in relative industries actually creates disincentives for investment. This was not the incentive of the law.

3. The rules for depreciation, capital gains rates, and investment tax credits are meant to stimulate net growth in the economy. We have seen that they may, instead, merely encourage interfirm transfers with no net benefit to society. The tax structure was not meant to encourage mergers. Policy makers should consider changes which make distinctions between real investments and the purchases of existing assets.

4. Finally, loss carry forward provisions create incentives for acquisition that can be substantial. In the absence of any economic justification for these provisions, they need to be reconsidered.

Chairman STARK. I am troubled by only one thing. Is there in fact a barrier to entry? In other words, I would feel more comfortable if I thought these chains who want to expand, which I think is a reasonable goal in business, could in fact expand. The Moonies are trying to do it here in Washington, but I submit that may be something that is outside the normal course of commerce. But aside from that, can you as a practical matter today start a newspaper?

Mr. DERTOUZOS. As a practical matter, because of the strong local economies of scale, it would be virtually impossible for a new firm to enter a market in which there already existed a newspaper.

Chairman STARK. Might that not explain the exaggerated price?

Mr. DERTOUZOS. To some extent it might. However, there are plenty of ways that a firm—there was a commenter previously who said that some of these tax incentives would create an incentive to diversify, and in fact the accumulated earnings provisions with respect to the newspaper industry actually create an incentive not to diversify, and in fact there are a variety of ways that several of the groups have found to expand.

There are countless markets out there that don't have daily newspapers. For example, the Gannett Corp. is starting a national newspaper at a very, very high investment. There are countless ways to expand and diversify. So although you are correct, it would be very difficult to enter an established market, there are several markets that do not currently have newspapers.

Chairman STARK. Go ahead, excuse the interruption.

Mr. DERTOUZOS. As a matter of fact, that probably just about concludes with what we had to say.

Chairman **Stark**. I would like to have the robust empirical part of your study. We usually have pretty sparse kinds of empirical evidence here that we could include in the record. If we could, why, I think it would add to the record. I would appreciate that.

If I may paraphrase your findings, the tax code is a major factor in causing newspaper mergers. While to some extent it may be the inheritance tax, did you find any examples of where you thought that the owners, through the death of one of the owners or the death of the sole owner, was going to pass the newspaper on to heirs or relatives where they just couldn't get the money to pay the inheritance tax?

I find that almost hard to believe. I can't imagine a situation where would have a couple of million dollars' worth of a newspaper before you had to pay any tax today. Anybody with those assets who wasn't anticipating some inheritance tax, and making provision to minimize that, well, it just would boggle the imagination to think that anybody could dream up a situation where they would really have to sell to pay the inheritance tax.

Mr. **Dertouzos**. It is very hard to believe.

Chairman **Stark**. Did you find any examples of that?

Mr. **Dertouzos**. I can't cite a specific example, but there are definitely examples of this, and part of the reason has to do with accumulated earnings penalty, that is, a reasonable business need does not include the need to retain for the purpose of paying future estate taxes, so therefore you cannot accumulate in anticipation of having to pay an estate tax.

Again, I recall that the current means of IRS valuation of a firm for estate tax purposes takes into account its value in transaction, and since that value in transaction is inflated by upwards of 25 percent, due to the tax advantages associated with purchasing a firm, it is very easy to write down an arithmetic example which shows quite clearly that the ongoing profits of a daily newspaper firm are in general not sufficient to pay the yearly tax liability due to estate taxes. So the two are very much interrelated, and in fact leads to the conclusion that some firms do have to sell. They cannot be passed on.

Chairman **Stark**. As I say, I look forward to seeing the empirical data that supports that, because the Chair thought that the contrary was the case. But I will read with great interest the details of your study. Thank you both, Mr. Dertouzos, and Mr. Thorpe, for being here and presenting this testimony. It will be an interesting part of the record.

Thank you very much.

Mr. **Dertouzos**. Thank you.

Chairman **Stark**. We now have a panel consisting of Mr. John S. Nolan, chairman of the Section of Taxation, American Bar Association; Prof. William D. Andrews, Harvard Law School; and Mr. Richard L. Bacon, Esq., Washington, D.C.

I believe, gentlemen, that we have copies of your testimony. I have not had a chance to read them, and I am only suspecting that this is the type of testimony that I will have to read as I move my finger, or else move my lips.

To spare the Chair the embarrassment of doing that in public, you might help me by summarizing it in the light of the other testimony you have heard today and by various areas of the bill. I would appreciate it.

I am just going to call on you in the order your names appear. That would put Mr. John Nolan first.

Welcome to the committee, Mr. Nolan. Your testimony will appear in the record in its entirety, as will any summary or clarification or expansion you care to add.

STATEMENT OF JOHN S. NOLAN, CHAIRMAN, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION

Mr. NOLAN. Thank you, Mr. Chairman.

My name is John S. Nolan. While I presently serve as chairman of the Section of Taxation of the American Bar Association, the short time since H.R. 6295 has become available has made it impossible to develop and obtain the position of the section or the association on this very important bill. Accordingly, this statement reflects only my personal views.

I am a member of a law firm that has advised, and is advising, clients as to transactions that would be affected by this bill if its provisions were effective with respect to such transactions.

I commend you, Mr. Chairman, for your initiative in introducing H.R. 6295 to address important issues of tax policy in corporate acquisitions. There is widespread agreement among tax experts as to the announced objective of the bill: the tax system should be neutral with respect to corporate takeovers. There is much in the bill with which I agree. There are, however, provisions that would require much more consideration.

This bill would make major changes in the tax treatment of corporate liquidations, corporate acquisitions of stock or assets, and carryovers in corporate acquisition transactions; such changes are designed primarily to deal with some specific corporate acquisition techniques that have come to light. In doing so, the bill would affect a broad range of corporate transactions that extends far beyond these specific problems. There is considerable doubt whether the extended reach of these changes, beyond the transactions at which they are specifically directed is justified or advisable; the breadth of these changes could impose severe hardships on smaller, closely-held corporations. The bill, for example, by eliminating the concept of a partial liquidation and expanding the imposition of a corporate-level tax on appreciation in value of assets, whether or not they have been indirectly sold to new owners, could create new discontinuities in the treatment of corporate shareholders.

This is a very important bill. It deals with an area which has been extensively studied by the American Law Institute and the Section of Taxation of the American Bar Association. It deals with an area in which major simplification is desperately needed. These questions are matters as to which the views and experience of the practicing bar are particularly needed. The solutions would benefit greatly from careful, dynamic interaction between the congressional tax staffs, the Treasury Department, and the practicing bar acting through its institutions such as the Section of Taxation of the American Bar Association. Accordingly, I urge you to hold further hearings after the tax bar has had more opportunity to consider the issues and formulate its views. I assure you that, if such an opportunity is given, the tax bar will respond in timely and objective fashion.

Title I would eliminate special treatment for partial liquidations and eliminate several of the exceptions to the rule that a corporation recognizes gain when it distributes appreciated property in redemption of its stock. A much simpler way to change the tax treatment of the transactions at which these changes are aimed would be for the Treasury Department to amend the consolidated return regulations. This would solve the immediate problem without the far-reaching consequences of a repeal of the partial liquidation provisions. If it appears necessary, the bill could contain a provision mandating such a change in the consolidated return regulations.

The much broader changes adopted in this bill, however, have very serious consequences that could adversely affect many entirely sound transactions. One effect of the bill, for example, would be to deny capital gain treatment to a distribution representing a bona fide contraction of corporate activities. A corporate contraction may be caused by the sale or destruction by fire or other casualty of significant corporate assets. A partial liquidation resulting from such a genuine contraction of the business is an extraordinary event. Such transactions may be more closely akin to complete liquidations than to stock redemptions.

The broad effect of the bill would also be to recognize gain at the corporate level on distribution of property in partial liquidation. The effect of such recognition when no gain is to be recognized, on complete liquidation, is equally questionable. The collapsible corporation provisions exist to prevent tax abuse in this area, and they will necessarily remain part of the code even if this bill is enacted. The pro rata distribution of assets constituting a separate trade or business in a partial liquidation, with the shareholders continuing to hold and operate such assets in partnership form, without sale by them, can serve important business purposes. It may even be an anti-takeover measure. The shareholders pay tax on such a distribution. It is by no means clear that a double tax should be paid.

Section 103 of the bill is directed at an entirely different form of acquisition transaction involving a purchase of stock in another company and then a redemption by the other company of that stock for stock of a subsidiary, of such other company—the so-called Mobil-Esmark transaction. Here again, the breadth of the remedy adopted in the bill may be inappropriate, given the scope of the problem. If the sale of stock and later redemption has been prearranged, the Internal Revenue Service could successfully attack the arrangement as a step transaction on the basis that it amounts to a sale of the subsidiary's stock by the target followed by a distribution by it of the sale proceeds in redemption of its own stock. Otherwise, the question addressed by section 103 of the bill is simply the broader question when a corporation should recognize gain or loss when it distributes property in redemption of its shareholders. If this problem is to be considered by Congress, it should be reviewed in the context of a general review of the entire existing and fundamental principle of our unintegrated corporate tax system that a corporation does not realize gain at the corporate level upon a distribution of its property to shareholders, whether as a dividend or in liquidation, except in certain redemptions and other narrowly-defined transactions. In other words, if the matter is to be reviewed, the entire General Utilities principle should be reviewed.

The shareholders pay tax in these situations; the issue is whether a double tax is justified, particularly where extraordinary distributions in liquidation are involved.

The first part of title II of the bill is addressed to a lack of symmetry in the present law between the tax treatment of a direct purchase of assets and an indirect purchase of assets upon a purchase of stock followed by a liquidation of the target corporation. The concepts embodied in Section 201 have considerable merit and deserve serious study. Section 201 in its present form, however, is highly complex, and could become a trap for the unwary small businessman. The use of statutory elections as to tax consequences presents special administrative difficulties and simplification problems. It requires very careful analysis by tax experts—the kind of analysis and interchange that have not as yet been possible with respect to this provision.

An approach which may be preferable to the complex one of the bill, at least until the matter can be given further intensive study, would be simply to shorten the time during which the target can remain a separate corporation. It would seem perfectly appropriate to provide that a step-up in basis will not be available on a liquidation of a subsidiary following a purchase of its stock unless the liquidation occurs within 1 year after the stock's purchase, or possibly even within a short period.

Section 203 of the bill would impose a toll charge for a step-up in basis of corporate assets, but the scope of its application is unclear and potentially unlimited. The transactions to which it would apply are not identified or limited, and the provision creates an in terrorem rule that could severely inhibit legitimate business transactions.

The principle that a step up in basis should be matched by gain recognition or recapture may well be sound, but here again, it would be more appropriate for such a principle to be considered in a comprehensive manner as to all types of corporate transactions, not just on a limited basis.

Section 301 of the bill would deny the use of carryovers to an acquiring company in a corporation acquisition unless there is very substantial continuity of stock ownership. The results would no longer depend upon the continuity of the business of the target company. The subcommittee may wish to consider whether it is wise in the current economic climate to discourage acquisitions of loss companies. Present tax law facilitates the acquisition by profitable corporations of companies that have encountered economic difficulties and the continuation of loss company businesses. This enables a financially strong company to try to revive another corporation's ailing business. The increasing number of corporate bankruptcies, some of them involving major businesses employing thousands of people, should be cause for concern, and Congress may wish to move slowly in eliminating provisions that encourage economically strong companies to acquire and continue businesses of financially weak ones.

The bill's proposed scheme is quite complex, and this additional complexity is a matter of serious concern from a policy standpoint. In at least five separate areas, the bill leaves detailed rules to be worked out by the Treasury Department in regulations. This would defer the adoption of operative rules, thus delaying the time by which taxpayers would have sufficient guidance to plan transactions.

This underscores my earlier suggestion that these provisions not be enacted until the professional tax community and interested groups have an opportunity to study them in detail and to consider their application to a wide variety of transactions. No such opportunity was given when section 382 was amended in 1976. The 1976 provisions have proved to be overly complex and unworkable. Congress has recognized this by deferring their effective date several times.

The provisions whereby the survival of each year's carryover depends upon continued stock ownership of persons who were shareholders that year to a year in which the carryover is used, while theoretically attractive, will be very difficult to administer. Since net operating losses can now be carried forward as long as 15 years, the application of the provisions in each carryforward year could depend on as many as 15 different lists of shareholders. Surely it is questionable whether the theoretical advantages of such an approach justify this degree of administrative complexity.

Congress should consider other methods of treating acquisitions of companies with net operating loss carryovers including the thoughtful approach of the American Law Institute, which relates limitations on the use of carryovers after an acquisition to postacquisition income.

Section 301 of the bill would amend section 368(a)(1)(F) of the code to make clear that reorganizations amounting to "a mere change in identity, form or place of organization" will include only transactions involving a single corporation. This proposed change has substantial merit, and I recommend its adoption.

Thank you very much.

[The prepared statement follows:]

STATEMENT OF JOHN S. NOLAN

My name is John S. Nolan. While I presently serve as Chairman of the Section of Taxation of the American Bar Association, an organization of more than 25,000 tax lawyers, the short time since H.R. 6925 has become available has made it impossible to develop and obtain the position of the Section or the Association on this very important bill. Accordingly, this statement does not reflect any position of those organization.

I am a member of a law firm that has advised, and is advising, clients as to transactions that would be affected by this bill if it provisions were effective with respect to such transactions.

The Section of Taxation held its Spring Meeting only one week ago, and I have had the benefit of discussion with many able members of the Section who are exports in the subject matter of this bill. Many of those individual views are reflected in the views expressed in this statement.

I commend your Chairman for his initiative in introducing H.R. 6295 to address important issues of tax policy in corporate acquisitions and for his thoughtful discussion of those issues in the floor statement. There is widespread agreement among tax experts as to the announced objective of the bill: the tax system should be neutral with respect to corporate takeovers so that it will neither encourage nor discourage such transactions. There is much in the bill with which I agree. There are, however, provisions that require much more consideration.

This bill would make major changes in the tax treatment of corporate liquidations, corporate acquisitions of stock or assets, and carryovers in corporate acquisition transactions; such changes are designed primarily to deal with some specific corporate acquisition techniques that have come to light. In doing so, the bill would affect a broad range of corporate transactions that extends far beyond these specific problems. There is considerable doubt whether such far-reaching changes are justified or advisable; they could impose severe hardships on smaller, closely-held corporations. The bill, for example, by eliminating the concept of a partial liquidation and expanding the imposition of a corporate-level tax on appreciation in value of assets, whether or not they have been indirectly sold to new owners, could create many new discontinuities in the treatment of corporate shareholders.

This is a very important bill. It deals with an area which has been extensively studied by the American Law Institute and the Section of Taxation of the American Bar Association. It deals with an area in which major simplification is desperately needed. I have been privileged to read the outstanding statement of Martin D. Ginsburg which is being submitted to you today; Professor Ginsburg is one of the country's leading experts on tax simplification, and he points out the fundamental tax policy questions and potential for simplification that exist in the issues addressed by this bill. There are serious questions whether this bill deals adequately with these basic considerations. It may well be that the specific problems at which this bill is aimed could be resolved by less Draconian changes, while reserving for more thorough but accelerated study, the deeper issues presented.

These questions are matters as to which the views and experience of the practicing bar are particularly needed. The solutions would benefit greatly from careful, dynamic interaction between the Congressional tax staffs, the Treasury Department, and the practicing bar acting through its institutions such as the Section of Taxation of the American Bar Association. Accordingly, I urge you to hold further hearings after the tax bar has had more opportunity to consider the issues and formulate its views. I assure you that, if such an opportunity is given, the tax bar will respond in timely and objective fashion.

GENERAL ANALYSIS

The bill is primarily aimed at—(1) the sale of a corporate subsidiary through a tender offer from the buyer to the parent corporation's shareholders followed by a distribution of the subsidiary's stock in redemption of the newly acquired shares; and (2) the purchase of stock of a corporation followed by its partial liquidation. Under some circumstances, both of these techniques may result in an increased asset basis without a corresponding recognition of gain or recapture of depreciation, investment tax credits, and similar items. The general approach of the bill in these situations is to require recapture or gain recognition as the price for a stepped-up basis. The bill would make substantial inroads in the rule of *General Utilities & Operating Company* v. *Helvering*, 296 U.S. 200 (1935), codified in Code §§ 311 and 336, that a corporation ordinarily does not recognize gain when it distributes appreciated property to its shareholders with respect to their stock.

The General Utilities principle has been eroded by statutory exceptions over the years, but it is still the starting point for an analysis of the tax consequences of distributions of appreciated property. There is considerable disagreement among tax professionals as to whether the principle should be changed, but if the general problem is to be addressed, this should be done in a systematic way, not in piecemeal manner. The bill would limit the application of this principle to a few specified situations in order to prevent certain perceived abuses in the corporate acquisition area. By creating more exceptions to the general rule that gain is not recognized when a corporation distributes appreciated property, the bill would add to the Code's complexities and lack of consistency. If instead the General Utilities problem were addressed in a comprehensive manner, all of its applications, including whether gain should be recognized upon the distribution of property as dividends or in complete liquidation, could be thoughtfully considered. Any such analysis should consider the carefully-developed study and recommendations of the American Law Institute.

The bill adopts broad solutions to limited problems. In order to eliminate certain tax benefits in several recent acquisitions, the bill would eliminate the entire existing tax treatment for all partial liquidations except to a very limited degree. In order to prevent the tender offer-redemption technique used in other recent well-publicized acquisitions, the bill would elminate most of the circumstances in which a corporation does not recognize gain on the distribution of appreciated property in redemption of its stock. Before adopting broad solutions to relatively narrow problems, Congress should be certain that the problems are serious ones, that they will be cured by the bill, and that they cannot be cured by less sweeping measures. A broad approach having implications beyond the corporate takeover area would be justified only in the context of an overall review of the tax structure of corporate acquisitions.

The bill attempts to achieve a greater measure of tax neutrality by eliminating differences in tax consequences of substantially similar transactions. This is certainly a sound objective. Toward the same end, the legislative recommendation of the American Bar Association developed by the Section of Taxation to provide uniform requirements for different types of corporate reorganizations should be carefully considered. Under present law, the tax-free reorganization area is filled with subtle distinctions which can produce widely diverse results in substantially identical transactions. The American Bar Association recommendation would eliminate most of these formal distinctions.

It is not clear that the bill would reduce corporate takeover activity. Although it would reduce the extent to which certain techniques could be used in order to achieve tax benefits, it is questionable whether the unavailability of these techniques would significantly affect any corporate acquisitions that otherwise would be made. The word "takeover" has come to produce certain emotive reactions. It suggests a hostile acquisition against the wishes of the acquired corporation's management followed by a greater concentration of economic power and, perhaps, by the closing of plants and shifting of operations to other parts of the country with resulting unemployment. It is not clear that the bill, which is rather narrowly focused, would inhibit this type of activity. Many of the specific transactions at which the bill is aimed require the active cooperation of the acquired corporation's management. Concerns as to economic concentration should be addressed through the antitrust laws, not the tax laws. In short, while tax policy issues presented by the bill deserve serious consideration, they should be evaluated as tax policy issues, not as anti-takeover ones.

The provisions of the bill would generally be effective as of August 31, 1982. It would be sounder tax policy to provide that the effective date will not precede the date of enactment. Proposed tax legislation should not freeze economic activity when there is a reasonable question whether Congress will eventually conclude that the policies reflected by the proposed legislation are desirable.

TITLE I.—PARTIAL LIQUIDATIONS; DISTRIBUTIONS OF APPRECIATED PROPERTY IN REDEMPTION OF STOCK

Title I would attempt to deal with the techniques at which it is directed by eliminating special treatment for partial liquidations and by eliminating several of the exceptions to the rule that a corporation recognizes gain when it distributes appreciated property in redemption of its stock. Although the present general rule that a corporation does not recognize gain when it distributes property in complete liquidation would be retained, an exception would be made if the liquidating corporation participated in a § 355 spin-off or transferred more than a de minimis amount of assets to another corporation in a § 351 transaction within the preceding five years. These latter provisions are intended to prevent transactions that are in essence partial liquidations from being brought within the form of a complete liquidation.

The Explanation indicates that repeal of the partial liquidation provisions is intended to prevent the use of the partial liquidation as an acquisition technique to obtain a step-up in basis of acquired assets without recapture consequences. Under present law, a corporation can buy the stock of a target corporation and redeem part of it for certain assets. If the acquiring corporation obtains 80 percent or more of the target's stock and files a consolidated return which includes the target, and if the redemption qualifies as a partial liquidation, the acquiring corporation obtains an immediate step-up basis for the assets received in the partial liquidation with no immediate recapture liability for the target. Investment tax credit recapture is avoided altogether, and depreciation recapture, although technically recognized, is deferred.

The lack of symmetry between the basis step-up and recapture provisions deserves attention. There should be investment tax credit recapture when the basis of acquired assets is stepped-up. It is not clear, however, that the significance of the problem justifies the breadth of the proposed remedy. The consolidated return regulations provide that depreciation recapture, although initially deferred in a partial liquidation, is taken into account as the stepped-up basis is recovered by the acquiring corporation through future depreciation deductions.

A much simpler way to correct any abuse in this transaction would be for the Treasury Department to amend the consolidated return regulations to provide for a recapture of investment tax credit on a partial liquidation and, if it appears justified on further study, to require recapture income to be recognized immediately. This would solve the immediate problem without the far-reaching consequences of a repeal of the partial liquidation provisions. If it appears necessary, the bill could contain a provision mandating such a change in the consolidated return regulations.

It has been a fundamental element of our tax treatment of corporations and shareholders at least since the Revenue Act of 1924 that shareholders receiving property in a partial liquidation are entitled to capital gain treatment even if the distributions are proportional to their stock holdings. Qualifying transactions include not only distributions of businesses described in present § 346(b) but also corporate contractions described in present § 346(a)(2). A corporate contraction may be caused by the sale or destruction by fire or other casualty of significant corporate assets. Partial liquidations are commonly used by closely held corporations to distribute assets when there is a genuine contraction of the business. They are extraordinary events. Most corporations never go through a partial liquidation and hardly ever go through more than one. Such transactions may be more closely akin to complete liquidations than to stock redemptions.

The bill would preserve capital gain treatment at the shareholder level for a type of partial liquidation—the distribution of a separate business under certain circumstances or the proceeds resulting from its sale—but it would eliminate capital gain treatment for corporate contractions. It seems clear that the repeal of the corporate contraction rule has no relationship to the announced objective of the bill, and it is not discussed in the Explanation.

The effect of the bill would also be to recognize gain at the corporate level on distribution of property in partial liquidation. The effect of such recognition, when no such gain is to be recognized on complete liquidation, is questionable. The collapsible corporation provisions exist to prevent tax abuse in this area, and they will necessarily remain part of the Code even if this bill is enacted. The pro rata distribution of assets constituting a separate trade or business in a partial liquidation, with the shareholders continuing to hold and operate such assets in partnership form, without sale by them, can serve important business purposes. It may even be an antitakeover measure. The shareholders pay tax on such a distribution. It is by no means clear that gain should also be recognized at the corporate level, with double taxation consequences, in such a case. This matter needs further study.

Section 103 of the bill is directed at a different form of acquisition transaction. A corporation desiring to buy a subsidiary of the target company makes a tender offer for amounts of target company stock. The target redeems the newly acquired shares from the buyer in exchange for stock of its subsidiary. Under § 311(d)(2)(B) of present law, the target company may escape recognition of gain on the distribution of its subsidiary's stock if—(1) the subsidiary is engaged in at least one trade or business; (2) the subsidiary has not received a substantial part of its assets from the target in exchange for its stock or as a contribution to capital within the five years before the distribution; and (3) the target company owned at least fifty percent in value of its stock at any time within the nine-year period ending one year before the distribution. The Explanation describes this transaction as amounting to avoidance of tax on the gain in what is in substance a sale of assets.

The problem addressed by § 103 of the bill may be more one of tax theory than corporate takeovers. Although the provisions in question to be repealed may be used in an acquisition context, it is doubtful that their availability would result in sales of subsidiaries that would not otherwise occur. Further, since the business being sold already exists as a corporate subsidiary, it seems unlikely that this type of transaction would result in greater economic concentration.

Until 1969, corporations generally did not recognize gain when they distributed appreciated property in redemption of their stock. The Tax Reform Act of 1969 reversed this presumption by enacting § 311(d) of the Code, which provides that gain will generally be recognized unless the redemption falls within certain specific exceptions. The legislative history of this provision indicates that Congress was primarily concerned with the distribution of portfolio securities by insurance companies in redemption of their stock. The exceptions seem designed to cover redemptions having a more general business or structural function. The bill would repeal § 311(d)(2)(B) and two other such exceptions to the rule that a corporation recognizes gain when it distributes appreciated property in redemption of its stock.

Here again, the breadth of the remedy may be inappropriate, given the scope of the problem. If the sale of stock and later redemption had been pre-arranged, the Internal Revenue Service could successfully attack the arrangement as a step transaction on the basis that it amounts to a sale of the subsidiary's stock by the target followed by a distribution by it of the sale proceeds in redemption of its own stock. See Edgar S. Idol, 38 T.C. 444 (1962), aff'd 319 F.2d 647 (8th Cir. 1963), Standard Linen Service, Inc., 33 T.C. 1 (1959), acq. 1960-2 C.B. 7.

Otherwise, the question addressed by § 103 of the bill is simply the broader question as to when a corporation should recognize gain or loss when it distributes property in redemption of its stock. If this problem is to be considered by Congress, it should be reviewed in the context of a general review of the entire General Utilities principle. A judgment should be made whether the distribution of property should be a taxable event for the corporation regardless of the form of the distribution. The bill addresses only stock redemptions and partial liquidations. Legislation in this area should also deal with the distribution of property as a dividend and in complete liquidation.

Even if the review is confined to stock redemptions, it would be appropriate to examine the entire problem as it relates to stock redemptions, not just the limited aspect focused on by the bill. For example, § 311(d) requires a corporation to recognize gain when it distributes appreciated property in redemption of its stock, but it does not allow it to recognize loss when it distributes depreciated property. If the distribution of property is to be a taxable event, it should be so treated regardless of whether gain or loss is involved. The other exceptions to the general rule of recognition should also be examined.

TITLE II.—PURCHASE OF STOCK AND STEP-UP IN BASIS; PURCHASE OF ASSETS AND STEP-UP

The first part of Title II of the bill is addressed to a lack of symmetry in present law between the tax treatment of a direct purchase of assets and an indirect purchase of assets upon a purchase of stock followed by a liquidation of the target corporation. If a corporation buys the target corporations's assets directly, the target recognizes gain immediately (unless it liquidates within one year under §337 of the Code) and its tax attributes are not available to the buyer. If, instead, the buyer acquires the target corporation's stock, it can use the target's tax attributes for up to five years and then liquidate the target, receiving a stepped-up basis to reflect the purchase price of its stock under §334(b)(2) of the Code.

Section 201 of the bill would eliminate this inconsistency by providing that a step-up in basis for the target's assets would not be available unless the buyer elected to have the target treated as if it had sold its assets in a §337 transaction as of the date of the stock purchase. Under proposed new §338 of the Code, the target would be treated as terminating its corporate existence on that date and, hence, its tax attributes would not be available in the consolidated returns filed by the buyer and its related corporations. After the transaction, the target would be treated as a "new" corporation. It would no longer be necessary to liquidate the target for this treatment to result. Section 334(b)(2) of the present law, which provides for a step-up in basis if a corporation's stock is purchased and it is liquidated pursuant to a plan of liquidation adopted within two years after the stock purchase, would be repealed.

The lack of parity between direct and indirect assets purchased as described in the Explanation has very doubtful relationship to corporate takeovers. It seems unlikely that the ability to operate a newly acquired subsidiary as a separate corporation within a consolidated return group for a few years would lead to takeovers that would not otherwise be made. Moreover, present law contains a number of provisions designed to prevent abuse in this situation.

Thus, the consolidated return regulations provide that pre-acquisition net operating loss carryovers of an acquired corporation may be used only against its own post-acquisition profits, even if it files consolidated returns with its new parent corporation. Although in theory a buyer could transfer profitable operations to its newly acquired subsidiary. Treasury Regulations provide that this may be evidence that the buyer's principal purpose for the acquisition was to obtain the benefit of the carryover, in which case its use could be denied under §269 of the code.

Application of the target's pre-acquisition losses against its own income, including depreciation recapture income resulting when it is completely liquidated by its new parent, would hardly seem to be an abuse. The losses were presumably increased by the depreciation deductions that are recaptured when the target is liquidated, and it would seem reasonable to allow them to be used to offset the recapture income at the time.

If the target company stays in existence after the acquisition, the transaction is not economically identical to the direct purchase of its assets by the buyer, and some differences in tax result do not seem offensive.

Notwithstanding the foregoing considerations, the concepts embodied in section 201 may have considerable merit and deserve serious study. Section 201 in its present form, however, is highly complex and could become a trap for the unwary small businessman. The use of statutory elections as to tax consequences presents special administrative difficulties and simplification problems. it requires very careful analysis by tax experts—the kind of analysis and interchange that have not as yet been possible with respect to this provision.

If Congress determines that a buyer's ability to use the target's tax attributes within the consolidated return group must be restricted in this bill, an approach preferable to the complex one of the bill would be simply to shorten the time during which the target can remain a separate corporation. Present law allows the liquidation to occur pursuant to a plan of liquidation adopted up to two years after the stock is purchased. The liquidation itself may extend for another three years. It would seem perfectly appropriate to provide that a step-up in basis will not be available on a liquidation of a subsidiary unless the liquidation occurs wihin one year after the stock's purchase, or possibly within even a shorter period.

Section 203 of the bill would impose a toll charge for a step-up in basis of corporate assets, but the scope of its application is unclear and potentially unlimited. A new § 346 would be added to the Code that seems intended to provide that the cost for a basis step-up on a complete liquidation will be complete recapture of investment tax credits, prior depreciation, and similar items, and that a distribution of assets by a continuing corporation will result in a basis step-up only if gain (not just recapture) is recognized with respect to the distributed assets. These rules do not apply to distributions to noncorporate shareholders. The transactions to which they would apply are not identified or limited, and the provision creates an in terrorem rule that could severely inhibit legitimate business transactions.

The principle that a step-up in basis should be matched by gain recognition or recapture may well be sound, but here again, it would be more appropriate for such a principle to be considered in a comprehensive manner as to all types of corporate transactions, not just on a limited basis.

The specific language of this provision needs clarification, as discussed in the attached technical comments.

TITLE III.—NET OPERATING LOSS CARRYOVERS

Section 301 of the bill would revise the present rules pertaining to the acquisition of corporations with net operating loss carryovers. The Explanation indicates that better rules "to restrict trafficking in loss companies should be part of any legislation dealing with unwarranted incentives for takeovers".

The new provisions would focus on continuity of stock ownership of shareholders from the year in which the loss is incurred to the year in which it is used. If continuity of shareholdings exceed 60 percent, the carryovers would not be reduced; if continuity falls below 20 percent, the carryovers would be eliminated. Carryovers would be reduced by 2.5 percent for each percentage point by which the loss year shareholders' interests fall below 60 percent. The same principles would apply to taxable purchases and tax-free reorganizations. With respect to taxable purchases, only shareholders with interests exceeding 5 percent of the corporation's stock would be considered. Shareholders with interests below that level would be aggregated and considered as one shareholder.

Although as a tax lawyer I have no special expertise in economics, there may be good reason in the current economic climate to encourage rather than discourage acquisitions of loss companies. Present tax law facilitates the acquisition by profitable corporations of companies that have encountered economic difficulties and the continuation of loss company businesses. This results from exisiting Code provisions where by net operating loss carryovers will survive the purchase of a loss corporation's stock if the corporation's business is not changed. This enables a financially strong company to try to revive another corporation's ailing business.

When the buyer continues the loss corporation's business, the transaction ordinarily will have been undertaken for legitimate business purposes, and it is questionable whether this should be described as "trafficking" in tax losses. Moreover, § 269 of the code provides that net operating loss carryovers will disappear if a corporation's stock is purchased for the primary purpose of obtaining their benefit. The increasing number of corporate bankruptcies, some of them involving major businesses employing thousands of people, should be cause for concern, and Congress may wish to move slowly in eliminating provisions that encourage economically strong companies to acquire and continue businesses of financially weak ones.

There is also a considerable body of sentiment within the professional tax community that the law should make it easier, not more difficult, for net operating loss carryovers to survive acquisitions. If the buyer is certain of getting the benefit of the target corporation's net operating loss carryovers, the target shareholders will be in a position to bargain for a higher price reflecting the value of future tax savings. The objective of loss carryover provisions is to recognize the limitations of the annual accounting concept in determining taxable income and to permit losses and profits to be offset to determine true taxable income. It is arguable that shareholders of a loss corporation have overpaid their taxes if loss carryovers still exist, and that it is fair and appropriate to permit them to recover those overpayments by sale to a buyer who may use the carryovers.

The bill's proposed scheme is quite complex, and a number of detailed suggestions relating its provisions are discussed in the attached technical comments. The additional complexity the bill would create is a matter of serious concern from a policy standpoint in and of itself. New concepts are introduced with new definitions and new rules of constructive ownership. In at least five separate areas, the bill leaves detailed rules to be worked out by the Treasury Department in regulations. This would defer the adoption of operative rules, thus delaying the time by which taxpayers would have sufficient guidance to plan transactions.

This underscores my earlier suggestion that these provisions not be enacted until the professional tax community and interested groups have an opportunity to study them in detail and to consider their application to a wide variety of transactions. No such opportunity was given when § 382 was amended in 1976. The 1976 provisions have proved to be overly complex and unworkable. Congress has recognized this by deferring their effective date several times.

The provisions whereby the survival of each year's carryover depends upon continued stock ownership of persons who were shareholders in that year to a year in which the carryover is used, while theoretically attractive, will be very difficult to administer. Since net operating losses can now be carried forward for as long as fifteen years, the application of the provisions in each carryforward year could depend on as many as fifteen different lists of shareholders. Surely it is questionable whether the theoretical advantages of such an approach justifies this degree of administrative complexity.

The percentage cutoff points seem somewhat arbitrary. Present law provides for no reduction of net operating loss carryovers in a taxable acquisition unless there is a 50 percent or more change in ownership. The bill would begin reducing carryovers if the change of ownership exceeded 40 percent. Thus, carryovers might be reduced even though the old shareholders continued to control the corporation. The rule of present law seems more reasonable. At the other end of the scale, the bill would completely eliminate carryovers even though the shareholders from the loss year retained up to 20 percent of the corporation's stock. The Explanation suggests that this is a natural corollary to the rule that the acquired company's tax attributes become fully available to the acquiring company on a consolidated return if 80 percent or more of the loss corporations's stock is acquired. There is no necessary relationship between these concepts, however, and it is not at all clear as a matter of tax principle that loss carryovers should be completely eliminated when the old shareholders have a significant continuing interest in the business.

The bill excepts changes of ownership resulting from gifts and bequests, and, to some extent, stock owned by creditors. The creditor exception applies only in Title II and similar cases and might be expanded. The 1976 legislation contained many more exceptions, and these should at least be considered.

Congress should consider other methods of treating acquisitions of corporations with net operating loss carryovers, including the thoughtful approach of the American Law Institute, which relates limitations on the use of carryovers after an acquisition to post-acquisition income.

TITLE III.—RFORGANIZATIONS CONSTITUTING CHANGES IN FORM

Section 302 of the bill would amend § 368(a)(1)(F) of the Code to make clear that reorganizations amounting to "a mere change in identify, form or place of organization" will include only transactions involving a single corporation.

This proposed change has sutstantial merit. Court cases have expanded the "F" reorganization to include combinations of different operating business corporations, in some cases with less than complete identify of shareholders. Section 381(b)(3) of the Code prohibits the carryback of post-acquisition net operating losses, but it does not apply to "F" reorganizations. This has enabled losses to be carried back from one corporation to pre-reorganization years of another. This probably was not intended by Congress. The "F" reorganization was not intended to include acquisitive transactions, and the treatment of net operating loss carryovers and other tax attributes in transactions involving separate functioning corporations should be dealt with under the normal acquisitive reorganization rules.

SUMMARY

The Subcommittee and its Staff are to be commended for taking the initiative in raising important quesitons of tax policy in the area of corporate acquisitions. The bill contains many ideas that deserve serious and thoughtful consideration. Congress should address these issues in a deliberate and comprehensive manner. The professional tax community is ready to provide extensive assistance in this effort.

TECHNICAL COMMENTS

TITLE I

Section 336(c) of the Code that would be added by § 104 of the bill would provide for limited recognition of gain on the complete liquidation of a corporation if the corporation had been a distributing or controlled corporation in a § 355 transaction within the preceding five years or if it was a transferor in a § 351 transaction other than of a de minimis amount of property. Some mechanism to prevent the avoidance of the repeal of the partial liquidation rules by spinning off assests before a purported complete liquidation is probably necessary, but this provision may go too far. It is difficult ot see why a corporation should be required to recognize gain on all of its assets when it liquidates if it had spun off a small business in an unrelated transaction four years before the liquidation at a time when liquidation was not contemplated. An exception to gain recognition should be provided if the prior transfer was not motivated by tax avoidance considerations or was not part of a plan contemplating the corporation's later liquidation. This could prevent the provision's application to an unrelated corporation that acquired the distributing corporation by merger and then itself liquidated—a result that could occur under the bill as presently drafted. An alternative approach would be to shorten the look-back period. A two-year period would certainly be adequate to preclude tax avoidance motivated transactions.

Section 336(c)(1) states that a corporation is subject to the rule if it is a distributing or controlled corporation in a § 355 transaction, but it is not by its terms limited to that situation. In order to remove any implication that the rule would apply to a corporation participating in a § 355 transaction as a shareholder, the word "only" should be added after "355" in the last sentence of § 366(c)(1).

TITLE II

New § 338(e) would give a corporation 60 days after the close of the twelve-month acquisition period in which to elect to be treated under § 338. This period should be extended, perhaps to 120 days. Although presumably an investigation of the target corporation would have been made before the acquisition, experience suggests that matters often come to light after an acquisition is completed that were not apparent beforehand. Sixty days does not seem to be long enough to enable the assembly and analysis of information that would be necessary to make an intelligent decision as to a § 338 election.

The references to "predecessor corporation" in § 336(c)(1) are unclear. The term should be defined.

The scope of the de minimis exception in § 336(c)(3) should be clarified. Does it apply only if the amount of assets transferred by the corporation in question was a small part of its own assets, or does it also apply if the transfer was of a significant part of the transferor's assets but was a small part of the assets of the transferee corporation?

The definition of "acquired corporation" in § 338(c) requires ownership of at least 80% of the total number of shares of all classes of non-voting stock other than that which is limited and preferred as to dividends. If this provision is concerned with the use of tax attributes in a consolidated return after an acquisition of stock, it would make sense for the definition of "acquired corporation" to be the same as that of § 1504(a)(2), which requires at least 80 percent ownership of each class of non-voting stock other than that which is limited and preferred as to dividends.

The bill is not clear whether the Internal Revenue Service would be able to contend in a particular case that a purchase of stock followed by a pre-arranged liquidation in fact amounted to an asset purchase without regard to § 338. Case law had established this principle before the 1954 Code, and the pre-1954 law might be revived by the repeal of § 334(b)(2). This might be covered in the committee reports.

Section 203 of the bill would add a new § 346 providing for a toll charge in order to secure a step-up in basis of assets in certain transactions. Section 346(a)(1) seems to require recapture in case of a complete liquidation, and § 346(a)(2) seems to require both recapture and recognition of gain with respect to assets currently distributed by a continuing corporation. Unfortunately, although the Technical Explanation indicates that this is the intent, the statutory language is not entirely clear. Both subparagraphs seem equally applicable to a complete liquidation or a current distribution. Moreover, the use of the word "or" between the two subparagraphs suggests that the corporation may have an election as to which of the two provisions to apply and, for that matter, whether to apply either. The provision suggests that the corporation has a choice whether to elect to receive a step-up in basis and pay the toll charge or to have a carryover basis and no toll charge. The extent to which the provision is elective and the election procedures to be used, should be clarified.

It will be very difficult for corporate management to justify electing to recognize gain at the corporate level in order to give a shareholder receiving distributions an increased basis in the property. It would not seem to be proper for management to elect to increase the corporation's tax liability in order to pass on a tax benefit to a particular shareholder at the expense of the other shareholders.

Section 346 refers to a "step-up" in basis of assets. Does this mean that the provision does not apply to assets with a value less than their basis?

The word "recapture" should be defined. Although it is commonly used to describe liabilities resulting from the disposition of depreciable property, or property with respect to which an investment tax credit has been claimed, it is not an operative word in the Code. Moreover, its application to the recovery of a previously-expensed item under tax benefit principles is unclear.

An exception is made under § 346(b)(1) for distributions "described in section 301(d)(1)." Section 301(d)(1) does not literally "describe" distributions. This provision would be clearer if it simply applied to "any distribution to a shareholder other than a corporation".

TITLE III.—NET OPERATING LOSS CARRYOVERS

The application of new § 382 to a combination of two corporations, both of which have net operating loss carryovers, is unclear. The definitions imply that only one company will be a "loss company".

Section 382(c)(2) is unclear as to the treatment of combinations of related corporations. The phrase "which is attributable" suggests that only stock received in the reorganization is counted, but the same sentence later provides that the continuing interest is the "stock of the new loss corporation owned by" the old loss corporation shareholders. Does this include stock that such shareholders owned before the reorganization?

The definition of "carryforward year" in § 382(d)(2) is not clear whether a year is a carryforward year if the net operating loss carryforward does not give rise to a deduction in that year because the tax on corporate profits for the year is eliminated by other allowances.

The meaning of the expression "midpoint" of a taxable year should be clarified. Does it refer to the last day of the sixth month of a full year or to the day which is literally the year's median date? What does the term mean in the context of a short year or one that might not end on the last day of a month?

Section 382(e)(1)(A) indicates that the family constructive ownership rules of §318(a) will be applied by assuming that the family status in the loss year is the same as the family status in the carryforward year, but it does not indicate which year has priority. If one is married during the loss year and divorced in the carryforward year, does the family status in the loss year or the family status in the carryforward year control?

Section 382(e)(6) authorizes the issuance of regulations indicating the circumstances in which changes in percentage ownership attributable "solely to fluctuations in the relative fair market values of different classes or amounts of stock" shall not be considered. This language is confusing. Any change in value is a "fluctuation". The provision does not seem literally to be limited to prescribing rules for treating differences of value between different classes of stock. A change in value could result from changes in the corporation's asset values, earnings, or a variety of other factors.

Section 382(g)(1)(B)(iii) excludes preferred stock which, in addition to other requirements, has redemption or liquidation rights that exceed neither the paid-in capital nor the par value represented by such stock "except for a reasonable redemption premium". The legislative history should provide some guidance as to how much of a premium would be considered reasonable. The statute should include in the stock's redemption or liquidation rights amounts representing accrued dividends.

TITLE III.—REORGANIZATIONS CONSTITUTING CHANGES IN FORM

This provision's literal language could be read to preclude a reincorporation in another state from qualifying as an "F" reorganization since such a transaction would involve two separate entities. The legislative history should indicate that this is not intended and that qualification is not prevented by capitalizing the new corporation with amounts necessary to pay organizational expenses.

Chairman STARK. Thank you very much, Mr. Nolan.

Your American Law Institute in brief says that carryovers are limited to income after the time of acquisition?

Mr. NOLAN. Yes. Professor Andrews is the expert on this subject, and I will leave it to him to describe them in more detail.

Chairman STARK. Thank you very much.

Professor Andrews, you drew the second shortest straw. You may proceed in any manner you would choose.

STATEMENT OF WILLIAM D. ANDREWS, PROFESSOR OF LAW, HARVARD LAW SCHOOL

Mr. ANDREWS. Thank you, Mr. Chairman.

In addition to teaching taxation at the Harvard Law School, for the last 8 years I have served as general reporter for subchapter C of the American Law Institute's study of Federal income taxation, and while I appear here completely in my own capacity, I do want to bring your attention to that and to the recently published report of that project, and indicate that it has some bearing on a number of the issues raised by this bill, and to indicate a willingness to pursue that relationship in any way that would be of interest to the committee.

Chairman STARK. Thank you very much.

Mr. ANDREWS. At the present time, however, I wish to testify solely on article 3 of the bill, concerning revision of section 382. That is one subject which was considered extensively in the American Law Institute study, and I wish to advocate briefly the change in approach suggested there.

Let me begin by saying that I am in full agreement with the purpose stated for limitation of loss carryovers. I think we should prevent solely tax motivated acquisitions or combinations. I think we should seek to make the tax law as neutral as we can with respect to corporate acquisitions, so that it presents neither incentives nor impediments to acquisitions or combinations that ought to occur. And finally in this area, I agree with the implicit purpose to find a relatively self-executing rule to accomplish all this; that is to say, I think we cannot depend as the older law has done on a direct evaluation of people's purposes in transactions, nor does it seem to be wise to try to trace the continuation of a particular business.

Now in response to that third purpose, what this bill represents is a continuation of an approach emerging from a kind of single operative rule, which is to disallow a percentage of loss carryovers or other tax attributes on any percentage change of ownership, and to relate the one percentage to the other, so that the larger the change of ownership, the larger a percentage of the tax attribute that is disallowed, and so forth.

Now, I think that this is one of those rules that turns out to be simpler to state than to implement, because it is off-target just enough so that exceptions proliferate around it. I think that can be best stated by talking about two polar situations.

There are, on the one hand, any number of cases of loss corporations in which there is still a business worth trying to preserve, and in which a change in ownership may be just what is needed, for reasons completely unrelated to the tax law. With respect to those situations, any rule that disallows a fixed fraction of the loss carryover on a change of ownership will present an impediment to the change of ownership which is just what we should be trying not to encourage but not to impede either. The results of that are that some acquisitions or combinations are prevented which ought to go forward on strictly nontax grounds. Moreover many combinations and acquisitions are severely distorted in form, in the effort to get the best out of the rule that has been imposed. Finally the statute itself is subject to a continuing pressure for exceptions of one kind and another.

Now, the other case to focus on is the other polar case. At least in theory, there are acquisitions in which the loss is the main thing worth thinking about, and acquisitions may be conducted solely for the purpose of acquiring a loss carryover.

With respect to those acquisitions, I submit that any approach which simply disallows a percentage of the loss carryover on a change in ownership of a percentage of the stock is not restrictive enough. There should not be any carryover of loss whatsoever in that situation, if we mean to accomplish the purposes of this provision.

Now title III in this bill represents, as I said, essentially a revision of that approach with the percentages being changed in a manner that makes it much more strict. As a result I think it considerably curbs the likelihood of solely tax-motivated acquisitions, in my second case, but only by severely aggravating the problem in the first case, severely aggravating the situation where a combination called for by nontax considerations will be impeded through the imposition of any limitation at all.

Now in the ALI project we have given that a good deal of thought, and come up with a different self-executing type of rule, which avoids both of those problems. That is, essentially, to put it in its simplest terms, to compute the limitation following an acquisition or combination by reference to the consideration paid in the acquisition or combination transaction. Then whenever you have a case in which the loss carryovers are a relatively small part of the whole thing, they will be allowed under that limitation, whereas when the loss carryovers are the whole thing, then a purchaser will simply be unable to pay a price that will support allowance of any part of that carryover.

Our proposal reduces to two rules: If there is a combination, a merger or similar combination, in which shareholders of the loss corporation receive 10 percent of the stock, for example, then the loss should be allowed only against 10 percent of subsequent earnings. The second rule governs an acquisition for cash, for example, in which our rule would say that the loss carryovers should simply be allowed only against a fixed rate of return on the purchase price paid, which I would think in the present climate would be something like 15 percent. The effect of that rule will be to prevent any acquisition solely for loss carryovers, since allowing loss carryovers to the extent of 15 percent cannot possibly pay the purchaser anything more than 7 percent on his investment, and therefore he will not make it for that purpose alone.

Implementation of this approach would not be simple, and the technical implementation of it would be different from what has been done before. The American Law Institute report contains 100 pages of elaboration which I think show that the implementation can be effectively accomplished. But the important thing is, however it may be done, that the rule itself would tend to protect the carryover that is merely incidental to an acquisition transaction while effectively completely eliminating the loss carryover when that is all there is, and I think that is what we ought to be aiming at in this situation.

I join other witnesses in commending the committee for raising these difficult issues, and I join you in hoping that they can be approached relatively promptly. Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF WILLIAM D. ANDREWS

My name is William D. Andrews, and I am a Professor of Law at Harvard Law School where I have taught income taxation for the last 19 years, and especially the taxation of corporate transactions. For the last eight years I have also served as Reporter for an examination by the American Law Institute of the income taxation of corporate acquisitions and distributions. The final report of that project is due to be published this month, and several of the proposals of the American Law Institute concern loss carryovers. I am here to urge that changes in the law concerning loss carryovers be made along the lines of the American Law Institute Proposal rather than those in the bill before the committee. While I urge the committee to follow the Institute proposal, I appear here solely on my own, not on behalf of the Institute or of any other organization or person or client.

The stated purpose for revising § 382 is to prevent loss carryovers from creating an unwarranted tax incentive for corporate takeovers. That is a purpose with which I fully agree. I believe, however, that the ALI Proposal would accomplish that purpose much more effectively than the provision in the bill.

Title III of the bill would continue to deal with loss carryovers in mergers and acquisitions by cutting down the amount of the loss carryover itself, proportionately, whenever there is a change of ownership of more than 40 percent of a loss corporation's shares. This general approach has indeed been urged in prior work sponsored by the American Law Institute, about 25 years ago, and was also reflected in the 1976 amendments to § 382.

This approach to the problem has proved difficult, however, to implement; the 1976 amendments to § 382 have been postponed several times and have still to take effect. The provisons in the current bill would meet some of the problems raised by the 1976 version but would raise others.

At the bottom, I think the present ALI Study has revealed that the difficulties result from the approach itself, for several reasons:

(1) Cutting down at all is undesirable in the case of carryovers that are merely incidental to an acquisition or combination that is mainly undertaken for other reasons. There are corporations for which the most desirable thing economically, aside from taxes, would be a combination with or acquisition by a healthy enterprise. Any limitation that simply cuts down loss carryovers will deter such combinations and acquisitions and lead to unproductive, unnatural attempts at avoidance. This objection is more serious the stricter the limitation.

(2) On the other hand, merely cutting down loss carryovers is insufficient when they are the main thing an acquired corporation has to offer. To take an extreme

case, consider a corporation with nothing but a $10,000,000 loss carryover. Now suppose it is acquired in a transaction in which the loss corporation shareholders are allowed to retain 40 percent of their stock. Under the limitation in the bill, standing by itself, loss carryovers would then still be allowed to the extent of $5,000,000, even though there was no nontax reason whatever for the acquisition. If the acquiring corporation is of the right size, there is no reason why it might not issue 40 percent of its stock solely for a $5,000,000 loss carryover.

What is needed then is a way to distinguish between cases in which the loss carryover is the main thing and cases in which it is merely incidental. Direct reference to the purpose of an acquisition (as under § 269) is unsatisfactory because of the difficulties of determining purpose. Limiting loss carryovers to profits from continuation of the loss corporation's business also raises difficult problems of determination, and may deter changes in use and operation of facilities that ought to be made.

What is needed then is a relatively mechanical test for distingishing incidental from excessive carryovers, and that is just what the ALI Proposal provides. Essentially, the proposal is that limitations on loss carryovers be set by reference to the magnitude of the total consideration paid for a loss corporation. Even existing law is too harsh when it disallows any part of a loss carryover that in only a minor incident in an acquisition transaction, and the proposal in the bill would be much more so; at the same time even the proposal in the bill is too lenient when it allows any fraction of a loss carryover in the absence of any other elements of value. Both defects can be alleviated by setting a ceiling on allowable carryover deductions that constitutes some function of the total consideration for the acquisition rather than a fixed fraction of the loss carryover itself.

More specifically, the proposal contains two rules of limitation. First, following a merger or similar combination, carryover deductions would be limited to the loss corporation shareholders' share of subsequent combined earnings. If loss corporation shareholders get 5 percent of the common stock in a merger, for example, then their corporation's loss carryovers would be allowable against 5 percent of subsequent earnings, and so forth. Second, following a purchase of more than half the shares of a loss corporation, carryover deductions would be limited to a specified, interest-like rate of return on the purchase price, but with generous exemptions for earnings allocable to unpurchased shares. If an acquisition is for cash and stock, then a limitation would be computed by reference to both rules.

Imposition of limitations on loss carryovers is inevitably a complicated business, and applications of these rules to specific transactions, particularly transactions tailored to fit the rules, will require a considerable elaboration of detail, in regulations and rulings if not in the statute itself. Extensive comments have been prepared in the ALI Report in order to illustrate and test how the rules in the proposal will work out in detailed application. That discussion shows that the rules in the proposal are indeed sound principles capable of generating coherent and sensible results in a wide variety of situations.

Attached is the text of The Institute's Proposal. I urge that the Committee give it serious study as a more effective way of dealing with the problem of loss carryovers in combination and acquisition transactions.

AMERICAN LAW INSTITUTE PROPOSAL CONCERNING SPECIAL LIMITATIONS ON NET OPERATING LOSS CARRYOVERS

PROPOSAL E1—SPECIAL LIMITATIONS ON NET OPERATING LOSS CARRYOVERS

The value of a loss carryover should be preserved but not augmented in the case of an acquistion or combination transaction. To that end, subsequent deductions on account of a prior operating loss should be limited in general to earnings allocable to capital of the loss corporation already invested when the loss was incurred, by applying the following specific limitations:

1. Corporate combinations and share issues—If a loss corporation is party to a merger or similar combination, or issues shares for money or other property or services, then subsequent deductions on account of any prior net operating loss should not be allowed to exceed earnings allocable to—

(A) shared of the loss corporation outstanding when the loss was incurred;

(B) shares issued to any creditor of the loss corporation in exchange for a claim against the loss corporation existing when the loss was incurred;

(C) shares of any other corporation a party to a combination with the loss corporation owned by a shareholder of the loss corporation when the loss was incurred, but only to the extent that his interest in such other corporation was identical with his interest in the loss corporation;

(D) other shares issued to and still owned by a person who has owned stock of the loss corporation since before the loss was incurred, except to the extent such owner's percentage interest exceeds [150] percent of what it was when the loss was incurred;

(E) any other shares issued solely for money or services if issued to and owned by persons who have not tansferred any property other than money to the corporation since the loss was incurred, but only to the extent such earnings do not exceed [100] percent of earnings allocable to outstanding shares of the loss corporation which represent identical interests still owned by the same persons as when the loss was incurred; and

(F) shares issued in exchange for any of the foregoing. A shareholder contribution to capital should be considered to involve an issue of shares of equal value for purposes of this rule.

2. Purchased shares—If any outstanding shares of a loss corporation are purchased, then subsequent deductions on account of any prior net operating loss should be subject to the limitation in rule 1 and in computing that limitation earnings allocable to any purchased shares should be counted only to the extent they do not exceed a specified rate of return on their purchase price.

(A) Shares should not be considered as purchased shares for the purpose of this rule—

(i) if not owned (or considered to be owned) by a person who owns (or is considered as owning) more than [5] percent in value of the outstanding stock (stock shall be considered to be owned for this purpose in accordance with the rules applicable in determining ownership under section 341(d)(1)); or

(ii) if purchased and still owned by a person who has owned stock of the loss corporation since before the loss was incurred, except to the extent such owner's percentage interest exceeds [150] percent of what it was when the loss was incurred.

(B) This rule 2 should not in any event be applied to limit deductions to less than [200] percent of earnings allocable to shares of the loss corporation which represent identical interests owned by the same persons as when the loss was incurred.

3. Transfers among related parties—For purposes of this proposal the following transfers of shares of a loss corporation should not be considered as purchases or as effecting any change in ownership:

(A) any transfer between spouses or between former spouses in connection with a divorce;

(B) any transfer by gift, bequest, devise or inheritance among family members, or any transfer in trust for the benefit of family members;

(C) any distribution from a trust or partnership to a beneficiary or partner; or

(D) any liquidating distribution by a corporation to its shareholders, except to the extent any shareholder receives more than his pro rata share of the loss-corporation shares.

4. Allocation of earnings—Earnings allocable to shares mean current earnings and profits allocable to such shares under regulations giving appropriate effect to any preference to which one class of stock is entitled as compared to any other, and also to any options, conversion rights, redemption rights or other special provisions that may alter the ultimate beneficial enjoyment of earnings from their apparent immediate allocation.

(Alternative 4. Allocation of earnings—earnings allocable to shares mean taxable income allocated among shares of a corporation in direct proportion to fair market value.)

COMMENTS

a. *General Purpose and Effect*

The effect of this proposal would be to preserve loss carryovers in acquisition and combination transactions for deduction against subsequent earnings attributable to capital contributed by the loss-corporation shareholders, while preventing use of such carryovers against earnings attributable to the contributions of other investors.

The purpose is to make the tax law more nearly neutral with respect to combination and acquisition transactions involving loss corporations by eliminating gross biases for or against such transactions. It is inconsistent with this purpose either to disallow loss carryovers entirely or to allow them without limitation, and the proposal therefore seeks to steer a middle course.

Complete disallowance of loss carryovers would create a bias against any transaction that triggered disallowance, at least if the were any prospects for utilizing the carryover if the transaction did not occur. This bias might be outweighed, of course, in any particular case, by other factors, but if the economic decision apart from taxes were a close one, disallowance of loss carryovers would be a distorting factor in evaluating a combination or acquisition transaction. The proposal seeks to minimize this bias by explicitly preserving loss carryovers for deduction against profits allocable to the continued investment of the capital of the loss corporation.

On the other hand, unlimited allowance of loss carryovers would create a substantial bias in favor of some combinations. In the absence of any combination, the value of a loss carryover depends upon the prospect of taxable earnings accruing to the loss corporation. In the case of a corporation that has suffered severe losses, the prospect of taxable income absorbing carryovers within the carryover period may be quite remote, so that the prospective value of a loss carryover is substantially less than its amount would suggest. A combination transaction might offer the prospect of marrying one constituent's loss carryover with another's profit prospects, thus enhancing the likelihood that the carryover can be fully utilized. This effect would create a bias that might make a combination profitable even if it produced no increase in pretax earnings or prospects. This proposal aims to minimize that bias by limiting deduction of loss carryovers to profits allocable to continued investment of the capital of the loss corporation.

A contribution of property for stock is similar to a merger in that it increases the pool of capital whose earnings may be offset against a loss carryover. Rule 1 in the proposal is therefore applicable to stock issues as well as mergers and similar combinations.

A purchase and sale of outstanding shares of a loss corporation has no direct effect on corporate capital or profit prospects. But purchasers of loss corporations often have profit opportunities that can be offered to the loss corporation, and that further step would enhance prospects for utilizing a loss carryover. Rule 2 would deal with this possibility by setting a ceiling based on the purchase price paid for the loss-corporation shares.

Strong arguments can be made for transforming the loss-carryover provision somehow into a device for partial recoupment of corporate losses. If this were done, there would be no need for special limitations of the kind in this proposal or otherwise. The proposal is based on the assumption that these arguments do not prevail, and that the loss-carryover provision is meant to perform only an averaging function.

Recognition of other purposes might well lead to differnet provisions. The Accelerated Cost Recovery System enacted in 1981, for example, is intended to stimulate investment by reducing the cost of depreciable property. A problem would arise in carrying out that purpose, however, for some taxpayers, since their income and tax is insufficient to absorb the new deductions and the investment credit provided. To deal with this problem, the Congress adopted special provisions authorizing leasing arrangements whose essential effect is simply to transfer deductions and credits to lessor-corporations with sufficient taxable income and tax liabilities to absorb them. Section 168(f)(8). To the extent, therefore, that net losses would otherwise arise from accelerated cost-recovery deductions, they have been made freely transferable by means of leasing, with the clear understanding that this will induce leasing transactions that serve no other purpose.

On the assumption, however, that the general loss-carryover provision is only meant to perform an averaging function, some limitations are needed. They should be designed, however, to minimize interference with economic decisions about buying, selling, combining, altering or terminating business operations, and that is the aim of the present proposal. Implementation of this proposal involves a number of substanital complexities, particularly in the face of complicated capital structures. it will help in dealing with those complexities if one keeps contstantly in mind the simple objective of preserving without enhancing the value of loss carryovers.

Chairman STARK. Thank you very much, Professor Andrews. I appreciate and find your approach to that operating loss carryover very intriguing. We will have a chance to look into that more.

Mr. Bacon, would you like to proceed. Your statement will appear in the record.

STATEMENT OF RICHARD L. BACON, WASHINGTON, D.C.

Mr. BACON. Thank you very much, Mr. Chairman.

I am here basically as an adjunct to the testimony of Professor Andrews, and to draw your attention also to title III of your bill H.R. 6295. By introducing title III, I think we have an excellent opportunity to make progress on a long-delayed subject; namely, the tax treatment of loss and credit carryovers after a corporate merger or stock purchase.

I would like to put some specific points on some aspects of the references to the American Law Institute project on loss carryovers which have appeared in the Treasury's testimony and in Mr. Nolan's testimony. I think we have here a proposal that is worth your further attention.

I think that title III of the bill is sound, in adopting uniform rules for all types of mergers and other takeover transactions, and in basing the uniform rules on changes in the stock ownership of a loss company. I do think that you may want to consider to adapt to the proposals of the American Law Institute.

I have submitted with my statement a modified proposal which makes some changes in what the American Law Institute proposes in the interest of eliminating some of the complexities that Professor Andrews referred to. The attachment to my statement attempts to get the rules as relatively simple as possible and as workable as possible.

What title III does is toughen fairly tough rules that are already in the law, although your bill would close the major loopholes in present law.

The concern that I would have is that title III of your bill, Mr. Stark, may not fully achieve the objectives that you have indicated you would like to achieve, that is, to have the tax law grant no special inducements to mergers, and at the same time not to put impediments in the way of legitimate, bona fide mergers. You have endorsement of those objectives by many of the witnesses at this hearing. Title III raises legitimate concerns in two ways.

One is by cutting down the loss carryovers themselves, which is what your bill would do. You would be taking away deductions, many of which were specifically put into the code to encourage a company to do something. The ACRS deductions which Congress enacted last year are simply one type of these accelerated deductions, but there are many others that cut across party lines and represent some sort of incentive to action by the company. If you take away the loss carryovers on a merger, you are likely to be destroying the incentive deductions which are built into those loss carryovers. Before you do that, you might look for a better way, if possible, which would still achieve your objectives.

The second problem that the American Law Institute proposal addresses is that whenever you make a judgment about where to begin cutting down the loss carryovers, you make a value judgment about the relative sizes of the companies that you allow to combine. For example, under present law, if a merger occurs between two companies, the present rule is that the owners of the loss company have to get at least 20 percent of the stock of the combined company. That means that the company making the acquisition cannot be more than four times larger than the loss company or the loss carryovers will begin to be scaled down. I am not sure we ever had any economic basis for that judgment that the acquiring company should be no more than four times larger than the loss company. It has simply been an unexamined rule in the law since 1954.

Your bill, Mr. Stark, would raise the 20-percent threshold for the full survival of carryovers to 60 percent. That means that in order for the loss carryovers to survive in full, the loss shareholders have to obtain at least 60 percent of the fair market value of the stock of the combined company. That in turn means that the loss company entering into this combination must be at least 50 percent larger than the profit company in order for the loss carryovers to survive in full.

I am not able to pass judgment on whether it is sound to begin cutting down loss carryovers only when the loss company is more than 150 percent larger than the profit company. I think that we tax lawyers are not in a position to make those kinds of judgments, and that, if possible, we should try to find a method or rule which does not confer special benefits but also does not impose impediments on a merger because of the relative size of the two companies which are parties to the merger.

There is a possible amendment to title III which will avoid those problems, that is, taking away the incentive deductions built into carryovers, and making economic judgments about the relative size of companies which are merging. That alternative is, as Professor Andrews has suggested, what the American Law Institute has proposed. The ALI concept would I think, avoid the disadvantages of title III and at the same time achieve the advantages of your bill. It would make the tax motives in an acquisition truly neutral. It simply would not pay anybody to acquire another company for the principal purpose of obtaining its loss carryovers.

For example, under the ALI modification, if you had a merger of two companies, in which the profit company gave out 5 percent of its stock to the owners of the loss company, the loss carryovers would be allowable in full—you would not directly eliminate them and take away the deductions that Congress has felt the company should have— but you would allow the carryovers against a portion, or what I would call a slice of the income of the combined company equal to 5 percent of its future income.

Let's consider one situation where that approach would have an advantage over the carryover reduction approach in your bill. In Professor Andrews' statement on page 2, an example is presented of a company with nothing but a $10 million loss carryover. Another party comes along and decides to acquire that loss company for roughly 40 cents on the dollar. The acquirer forms another company, merges the loss company into it and gives the owners of the loss company 40 percent of the stock on the combined enterprise. Under the formula in title III of H.R. 6295, the loss carryover would be reduced by 50 percent to $5 million.

That carryover, even as reduced, may be quite an advantage to the acquiring party. How would the same transaction be treated under the American Law Institute approach? The loss carryover would only be allowed against the income attributable to the amount of stock given to the owners of the loss company. Let's suppose that in the example the profit company decided to give preferred stock to the owners of the loss company: preferred stock whose fair market value constitutes 40 percent of the combined company. In that case, the loss company's owners would have a preferred stock interest in the combined enterprise and would not share in the future growth represented in the common stock. Under the alternative approach, if preferred stock is given to the owners of the loss company, the dollar amount of the loss carryover would survive, but it would only survive against the dividends paid or accrued on the preferred stock—or an equivalent deemed rate of return. That can be a very small amount if the owners of the profit company really saw no value in the loss company and were simply acquiring it for the loss carryover.

If common stock were issued in the merger, carryovers would be allowable only against a share of future combined earnings allocable to that common stock issued to the loss company's owner's. Under this ALI rule, in order for an acquisition to be economic, the party that comes along and wants to take over the loss company really has to see some earnings potential in the loss company because the profit company has to give out stock whose earnings are going to be the measure of the allowance of the loss carryovers. If the owners of the profit company see nothing but a shell and there are no assets there to generate any future earnings, they are simply not going to make the acquisition because it is not going to pay to give out 40 percent of your common stock and only be able to realize the tax savings on those earnings. The loss carryover could not shelter other earnings.

You have to give out $1 million in order to realize 46 percent of those earnings but no more. You are simply not going to acquire a loss company primarily for the loss carryovers.

So, the advantages, I think, of the approach that you have heard described to you today is, first, that the tax law would be neutral in an acquisition independent of the relative size of the combining companies. Tax motives could not be the dominant factor in the acquisition and you would preserve the incentive deductions which are built into the carryovers. Those are major advantages which I think would improve your bill. I think title III could be adapted to this approach without much difficulty.

Professor Andrews mentioned complexity in the ALI approach. I think complexity is a relative matter. Accountants and lawyers can make the necessary calculations of the amount of income that would be necessary to absorb the carryovers. The advantages of the approach I have mentioned far exceed the accounting work that would be required and that accountants would normally be expected to do under any set of rules that we adopt.

I think this approach could be the magic bullet that we are looking for in this area and I would urge you, Mr. Stark, to consider it as an amendment and refinement to the basic sound approach in title III of your bill.

[The prepared statement follows:]

Statement of Richard L. Bacon, Silverstein & Mullens, Washington, D.C.

SUMMARY OF POINTS COVERED

1. The basic philosophy of title III of H.R. 6295 in applying uniform tests to all types of corporate acquisitions is sound and long overdue. The principle of basing

the uniform test on changes in the stock ownership of a loss company is also and important improvement over present law. I suggest amending only one part of the proposal so as not to reduce the loss carryovers themselves once the limitations are triggered.

2. With the above modification, title III would:

(1) Trigger limitations by changes in the stock ownership of a loss company (as title III does), but then

(2) Allow loss carryovers (without reduction in dollar amount) against a portion of post-merger income allocable to the continuing interest of the loss company's shareholders.

3. Title III should also be strengthened by covering "built-in losses" as well as loss carryovers.

STATEMENT

Mr. Chairman and members of the Subcommittee, my name is Richard L. Bacon. I am a tax lawyer engaged in private practice in Washington. I am appearing on my own behalf and not on behalf of any special interest or group. I was a member of the staff of the Joint Tax Committee in 1976 and had an opportunity to participate in the development of the 1976 Act amendments to the loss carryover provisions, the basic philosophy of which is reflected in Title III of H.R. 6295. It is this part of H.R. 6295 I would like to address this morning. During this past year I have also been chairman of a special task force within the Tax Section of the American Bar Association charged with studying recent proposals in the loss carryover area put forth by a distinguished group of practitioners and scholars in the American Law Institute. I am not speaking officially for the task force, however.

Your statement on H.R. 6295 expresses an objective to "make the tax system more nearly neutral with respect to corporate takeovers" and says that "the tax system should create neither special benefits from nor impediments to mergers, acquisitions, or reorganizations." I second these objectives. But I would like to propose several amendments intended to achieve these goals more fully. I would first suggest strengthening Title III by including so-called "built-in deductions" within its scope. Second, I would ask that you consider an alternative type of limitation which builds on the American Law Institute proposal and could be blended with the good features already in Title III. This modification of one part of Title III will result in your bill doing even a better job of making the tax system truly neutral in the takeover process.

I have prepared an Outline of the alternative which I have submitted with this Statement.

We certainly should take a new look at the loss and credit carryover rules. The recent increase in the loss carryover period from 7 to 15 years sets up many loss companies as juicy targets for profit companies seeking tax shelters. More significantly, a "net operating loss" also no longer necessarily denotes financial trouble; it now includes many companies which are entirely healthy, yet are the recipients of incentive-type deductions which Congress wants them to have but which they cannot fully absorb. If the new safe harbor leasing rules are cut back or repealed, it is likely that many tax-motivated mergers will occur to enable profitable acquirers to take advantage of accelerated deductions (such as ACRS) which comprise a new breed of "artificial" losses.

Present law triggers limitations on loss carryovers when certain major changes in the stock ownership of a loss company occur (and in some cases when both a change of ownership and a change in business occur). The Tax Reform Act of 1976 eliminated the business test, so that neither a continuation of the company's business by new owners nor abandonment of the existing business would help or hurt the survival of carryovers. Title III retains this basic "trigger" for limitations on loss and credit carryovers, that is, changes in the stock ownership of a loss company (without regard to continuation of, changes in, or abandonment of the existing business).

Once the limitations are triggered, however, all of the existing versions of these rules (including Title III) limit the carryover by reducing, or scaling down—or in some cases eliminating entirely—the dollar amount of the carryovers themselves. Where a statutory merger occurs, for example, the former owners of the loss company must presently retain at least 20 percent of the stock of the combined enterprise in order for the loss carryovers to survive in full. Otherwise the dollar amount of the carryovers is scaled down proportionately as the former owners receive less than 20 percent. The Stark bill would raise this threshold to a minimum 60 percent ownership of the combined enterprise and, at 20 percent ownership of the acquiring company, eliminate the loss carryovers entirely—despite a continuing 20 percent minority interest of former owners of the loss company.

A major concern I have with this approach of reducing carryovers themselves is that nontax value judgments are necessarily made when we decide at what point to begin "guillotining" the carryovers. The carryovers now survive a merger only if the acquiring company is no more than 4 times bigger than the loss company. The 1976 Act amendment (whose effective date has been deferred until 1984) allows all the carryovers only if the acquiring company is no more than 1½ times the size of the loss company. Title III requires that the loss company must in fact be larger than the acquiring company by 50 percent for the carryovers to survive in full. What rational reason do we have for these judgments? Even if we think (as I do) that a 60 percent continuity threshold is too high, and then try to arrive at a "better" or "more realistic" cutoff point, we will be favoring certain size mergers and penalizing others. This kind of rule does not make the tax law neutral. It helps or hurts mergers depending on the relative sizes of the parties to the transaction. We could prohibit the survival of tax attributes altogether after a merger if we choose to, but if we allow tax attributes as a general rule to carry over after a tax-free reorganization, as the law now does, it seems to me that we want to make taxes a neutral factor regardless of the relative sizes of the merging companies.

I also do not think that we tax people are in a position, or that we have the expertise, to make these kinds of relative economic judgments. The antitrust committees should deal with such questions outside the tax law.

I also suggest that the "incentive" policies underlying many business expense deductions—including ACRS or any other accelerated deductions Congress sees fit to encourage—should not be lost by cutting down the carryovers themselves. The carryovers increasingly reflect expenditures you want the company to make. And the dollar amount of the carryovers does not bear any reasonable relation to the percentage of loss company shareholders who continue on after a merger or other type of takeover.[1]

There would be real advantages in the following amendment to Title III. Retain the basic structure of Title III initially triggering loss and credit carryover limitations by changes in the stock ownership of a loss company. These changes will reflect takeover transactions. However, allow the loss carryovers (whatever their dollar amount) to offset only a portion of the earnings of the combined enterprise allocable to the loss company's shareholders. So, in a merger, if a profit company acquires a loss company for 5 percent of the combined stock of both companies, the carryovers would be allowable each year only against 5 percent of the future earnings.[2] The merger in effect expands the capital pool of the loss company and represents an investment of its capital for the benefit of its shareholders. If the loss company had in fact entered into a joint venture with the profit company, its share of the profits could be offset by its own carryovers but no more; the other party's share of profits would be fully taxable to it. A merger should produce an equivalent result, because the tax value of the loss company's assets (and its carryovers) which it contributes to the "joint venture" will be taken into account in setting the exchange ratio which fixes the extent of the loss company's participation in the "venture."

Under the suggested modification, it would still never pay for an acquirer to go after a loss company primarily for its tax losses or investment credit carryovers. The tax saving from using the carryover would not exceed the earnings which the acquirer would have to "pay" to the loss company's owners in order to obtain those carryovers. No matter what two relative sizes you compare, it would always cost the acquirer more in terms of the claim on its earnings or dividends it has to pay than the 46 percent (more or less) it could obtain in tax savings from the carryovers. No one could "traffic" in loss carryovers under such a rule, even for 10 cents on the dollar. This rule would be entirely self-regulating, because whatever interest in the company is given to the loss company's shareholders, the tax saving from the carryovers could at most be only 46 percent of those earnings (and no more), be they large or small in absolute dollar amount. The motives for a takeover would have to arise from factors other than past tax attributes. The tax law would also be completely neutral concerning the relative sizes of the merging companies, and the incentives built into the credits and carryovers would not be taken away.

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[1] The loss carryover provisions of Title III also have a number of other lesser policy problems. Title III measures changes in stock ownership by looking back to each loss year when a net operating loss was sustained and then to the year when the loss will be used. This total period could cover up to 15 years. This long span could cause difficult verification problems.

Even if you adhere to the approach of reducing carryovers themselves, requiring a 60 percent continuity by the loss company's shareholders is too high a threshold. Also, I do not think the bill should eliminate the carryover entirely where the loss company's former owners (or some of them) continue to own as much as 20 percent of the combined company after a merger.

Title III also deletes (without mention) a special rule added Congress in 1981 to adapt the loss carryover rules to supervisory mergers of savings and loan associations. See present sec. 383(b)(7)(B). Absent a specific change in the Congressional policy on this point, the special rule should be restored to the bill.

[2] If preferred stock is issued, carryovers would be allowable against earnings equal to divideds paid or accrued on that preferred stock (or perhaps a deemed rate of return equal to an average prevailing interest rate, regardless of actual dividends paid), but no more.

As I mentioned at the outset, I would recommend broadening the scope of Title III to include so-called "built-in" losses and other deductions which have economically accrued at the date of a merger but have not yet been realized at that point. Title III would not reach these losses. We already reach built-in losses in the consolidated return area, and the American Law Institute proposes broadening this policy. This addition would strengthen your proposal.

I would modify some of the specific rules of the ALI proposal. However, the details can be fine tuned with the Staff, if you will give a green light to the policy in this refinement of Title III. We can perfect Title III to achieve all that you want to achieve, Mr. Chairman. The proposed amendment will, I believe, also make Title III more saleable politically because you keep the incentive deductions intact. Any proposal that can achieve all these things could be the "magic bullet" we are looking for.

Thank you.

LOSS AND CREDIT CARRYOVER PROPOSAL

These rules would apply to net operating loss and capital loss carryovers, other carryovers covered by present section 383, and to "built-in" deductions and losses.

The Secretary will have authority to adopt analogous rules allowing credit carryovers against a share of post-acquisition tax liabilities. (These rules would affect investment credit carryovers and other credit carryovers subject to section 383 of present law).

A. Triggering events: Change in stock ownership transactions

1. General rule.—Limitations will be triggered by a change in stock ownership of a loss company.

(a) "Change in stock ownership" means a transaction resulting in an increase in one or more shareholders' proportionate interests in the assets or earnings and profits of the corporation, by means of taxfree reorganizations, new issues of stock for cash or property (or services) in a section 351 transaction or any other transaction covered by section 1032, or a taxable purchase of stock from an existing shareholder.

(b) A contribution to capital by a shareholder will be deemed to involve an issue of common stock of a value equal to the fair market value of the contribution.

(c) Any change in stock ownership by means other than a taxfree exchange will be determined by reference to any one or more of the 10 largest shareholders of the company (by value of total outstanding stock) as of the end of the current year, and will measure their increase in stock ownership back to the beginning of the third preceding taxable year. Less than 5 percent shareholders will be excluded. Constructive ownership rules (including option attribution) will apply.

2. Exceptions.—These provisions will not apply to:

(a) Stock in a loss company acquired by gift, bequest or inheritance; transfers in trust for the benefit of family members (including transfers in connection with a divorce or smaller marital separation).

(b) Stock acquisitions by key employees and by qualified employee trusts.

(c) Redemptions and recapitalizations under § 368(a)(1)(E), unless stock was acquired for the purpose of participating in the transaction.

(d) Distributions of stock from a trust or partnership to a beneficiary or partner.

(e) Liquidating distributions by a corporation to its shareholders, except to the extent any shareholder receives more than his pro rata share of stock in a loss company.

B. Amount of carryovers allowed

The limitations will apply to carryovers from the taxable year in which a change in ownership occurs and to carryovers from prior taxable years to that year and future years.

1. Issuance of common stock.

Where common stock of the loss company (or of a company which acquires the loss company in a taxfree reorganization) is issued as a result of a change in ownership, carryover deductions would be allowable each year only against subsequent earnings allocable to—

(a) shares of the loss company outstanding immediately before the reorganization or new issue of stock;

(b) shares issued to preexisting shareholders up to, but not in excess of, twice the percentage ownership (up to 100 percentage points) owned by such shareholder;

(c) shares issued solely for money or services, but only up to (and not in excess of) earnings allocable to 50 percent in value of the total outstanding stock immediately before the new issue of stock;

(d) shares issued to a creditor in exchange for a claim against the loss company held by the same creditor at the end of the year in which the particular loss embodied in a carryover was sustained; and

(e) shares of an acquiring company (or of a company in control of the acquiring company) issued in an exchange (in which gain or loss is not recognized in whole or in part) for any of the above shares.

2. Issuance of preferred stock.

(a) Where preferred stock is issued in exchange for existing stock of the loss company in a merger or other taxfree reorganization, carryover deductions could offset only the amount of subsequent earnings equal to a specified rate of return on such stock intended to approximate an existing "going" rate of interest or dividends. (An alternative might limit carryovers to actual dividends paid or accrued on the preferred stock; the Secretary could then specify a different rate of return to be used if needed to prevent unreasonable dividend preferences).

(b) If preferred stock of the loss company is issued to new investors, carryovers would be allowable only against future earningss allocable to the preexisting common and preferred stock of the company.

Exception: this limitation in (b) would not apply to preferred stock issued solely for money or services and whose fair market value constitutes no more than 50 percent of the fair market value of the total outstanding stock. If this threshold is exceeded, carryovers would be allowable against earnings allocable to (i) preexisting classes of stock, plus (ii) dividends paid or accrued on the new preferred stock representing up to 50 percent of the value of the total outstanding stock.

3. Purchase of stock from existing shareholders where gain or loss is recognized in whole or in part.

If one or more new investors or existing shareholders purchase stock from other shareholders and increase their percentage ownership of the loss company's stock (by fair market value of all classes) by more than 50 percentage points during the current taxable year and/or during the preceding 3 taxable years,[1] loss carryovers would be allowed against a percentage of future earnings allocable to:

(a) The stock ownership percentage (by value of all outstainding stock) retained by other shareholders, plus

(b) The interest rate payable on the purchase price (if a debt obligation is issued by the purchaser) [2] or an imputed interest rate if cash is paid.[3]

Possible special rule: an existing shareholder might be allowed to increase his stock interest to twice the percentage he owned at the start of the lookback period before this limitation will come into play.

C. Special rules

1. Earnings "allocable" to stock received or retained by owners of the loss company will be determined by reference to after-tax earnings, i.e., current earnings and profits, under regulations prescribed by the Secretary. Regulations will give effect to preferences, options, conversion or redemption rights, and other special features of stock which may alter the ultimate beneficial enjoyment of earnings.

2. "Built-in" losses and deductions would be relatively large items realized within 10 years after the merger or other change in stock ownership. (Definitions similar to those in Reg. § 1.1502-15(a)(4)(i) could be used for this purpose.)

RELATED AMENDMENTS

1. Section 269 will not apply to any carryovers allowable under the proposal.

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[1] Redemptions and recapitalizations from other shareholders during this period would be taken into account in measuring such increase.

[2] Alternatively, a deemed interest rate might be used approximating the average prevailing interest rate (rather than the interest rate actually payable on the buyer's obligation).

[3] E.g., the midpoint of the range of rates considered reasonable for purposes of section 385. See Prop. Reg. § 1.385-6(f).

2. The Secretary would have authority to adopt regulations dealing with carryovers following a spinoff, splitoff, or split-up under sec. 355 of the Code.

Chairman STARK. Thank you very much, Mr. Bacon.

Let me see if I understood you.

What you are suggesting is that we don't cut down the net operating loss of a company if it is acquired in a merger because we would be frustrating some of the social or economic incentives that we built into the code.

I wonder if that holds. I can't believe that people make a decision at a point in time to make a charitable contribution or invest in capital goods that will take advantage of the accelerated cost with the idea that at some unknown time in the future they will indeed merge out and sell their accumulated net operating loss.

It is disingenuous, at least to me, that management has figured out a way, with the advent of computers, to anticipate that.

Mr. BACON. I don't think we are saying that the company anticipates anything. The company doesn't have to anticipate anything. The loss company simply has to go about its business of buying assets, taking advantage of the ACRS system, for example, which gives generous deductions and then somebody else comes along and makes a tender offer, which results in acquiring the loss company voluntarily or involuntarily.

Chairman STARK. Well, they go out of business. That always seems to be the alternative that we ignore.

I have always thought that was perhaps a fairly sound alternative. They just disappear.

Mr. BACON. Well, the advantage of the American Law Institute proposal is that there would be no incentive to stay in business or go out of business.

Chairman STARK. I am not quarreling with your proposal. I find it intriguing and I think it has merit. I was just trying to get back at one of your objections about reducing the use of loss carryovers. Somehow if that opportunity weren't there it would reduce the incentive for healthy corporations. One presumes that you have relatively healthy corporations taking advantage of tax incentives. I think certainly the expectation of making money is there or they wouldn't be doing it.

I find that puzzling. Perhaps I didn't fully undertand it but if it is outlined in your written testimony, I will catch up.

I want to thank all of you. I found your testimony extremely interesting and constructive and I hope that we will have a chance to inquire of you and have some of your advice to benefit members of the committee and staff as we try to do something with this.

It is very good of you to mobilize on short notice and we will try and stay in touch.

Thank you very much.

The committee will recess until 5 after 2.

[Brief recess.]

Chairman STARK. If Mr. Brown and Mr. McCormack and Mr. Bloom would come forward, which are our final panel of the day. Mr. Earl C. Brown, tax partner of Arthur Andersen & Co.; Mr. Michael J. McCormack, partner at Deloitte, Haskins & Sells; Mr. Gilbert D. Bloom, partner of Peat, Marwick, Mitchell & Co.

I would like to welcome you gentlemen to the committee and I know that you understand that it is the policy of the Chair to always save the best for last. I apologize for keeping you away from your luncheon but that might have been at the expense of keeping you away from catching your plane or your commute home, so I hope you will indulge us.

We have your prepared statements. We want to thank you very much for presenting them to us in advance. I would ask you to proceed to summarize or elaborate on your statements as you see fit and perhaps you could start out in the order we called you and that would put Mr. Brown first.

STATEMENT OF EARL C. BROWN, TAX PARTNER, ARTHUR ANDERSEN & CO.

Mr. **Brown**. Thank you, Mr. Chairman.

My testimony today relates to the fact that I am the head of the corporate reorganization tax specialty team and head of the Chicago merger and acquisition program for Arthur Andersen.

I welcome the opportunity to testify today on the subject of the proposed Corporate Takeover Tax Act of 1982 and related legislation.

In the interest of time, though, my comments will focus on H.R. 6259. We find that H.R. 6259 is overly far reaching in its attempt to correct a perceived abuse. The press release announcing these hearings suggest that the subcommittee is concerned that an increasing number of corporate takeovers appear to be motivated by or at least tailored to the tax benefits which may be obtained under the present law.

Apparently, the subcommittee believes that these kinds of corporate activities arise exclusively from the motivation to derive tax benefits. We reject that assumption.

My testimony today will attempt to describe to the committee the economic motivations behind these activities and the actual disincentives that occur in present law.

The chief impetus behind virtually every corporate acquisition has consisted of a desire to acquire the business and/or assets of the acquired company, not the tax attributes.

Competent business people are certainly cognizant of the tax aspects of various corporate actions. Nonetheless, these tax effects do not override the ultimate economic decision to be made which is whether the acquisition makes sense from a business standpoint.

Even if tax attributes and not the desire to own the business or assets of the acquired company were the primary motivating factor for the transaction, there are presently sections in the code that deal with acquisitions where the principal purpose is to avoid taxes.

Therefore, the realities of business experience should teach us that the background and underlying assumptions upon which this proposed legislation is based is erroneous.

There is present disincentives in the tax law whch I will try to cover quickly. The Internal Revenue Code currently provides for two basic types of corporate acquisitions: Tax-free acquisitions under the reorganization provisions and taxable acquisitions which are often purchases that are structured under the liquidation provisions of subchapter C of the Internal Revenue Code.

The term "tax-free" acquisition is really a misnomer. Simply stated, not all the consideration received in a reorganization is tax free. Rather, the only consideration which is tax free is stock or securities of the acquiring corporation.

In a reorganization, shareholders of the acquired corporation may often receive millions of dollars in cash and pay significant tax on the cash received. In that same transaction, the acquiring company in the reorganization receives absolutely no additional tax basis in the assets that are acquired, even though it has paid, sometimes, millions of dollars of cash.

Thus, it should be clear that the current reorganization provisions may create a substantial economic disincentive to an acquisition if it is structured as a reorganization since the acquiring corporation receives no additional tax basis even though it may have spent substantial sums of money.

One example that has been talked of this morning is the DuPont acquisition of Conoco. The concept underlying the ability of the corporation to allocate the purchase price of the stock of an acquired corporation to its underlying assets is essentially one of cost recovery.

The concept of cost recovery certainly is in accord with established tax principles.

The introductory remarks to H.R. 6259 and some of the publicity that has surrounded both the legislation and the recent events in the marketplace seem to suggest that a pervasive belief that corporate takeovers can be structured to achieve significant tax benefits.

Recent publicity seems to suggest that takeovers can be structured so that the buyer receives the same tax benefits he would have had if it had purchased the assets directly without incurring the tax consequences to the seller, the recognition of gain and recapture of depreciation.

Both the facts and the law underscore the fallacies of these presumptions. A shareholder who sells his stock will recognize gain, assuming the proceeds received exceed the adjusted tax bases of the assets sold.

In point of fact, the tax on the gain paid by the selling shareholders may well exceed the present value of any future tax benefits to be received by the purchaser.

Additionally, under present tax rules, the tax consequences of depreciation recapture is not avoided.

In the case of a stock purchase followed either by a complete or partial liquidation, depreciation recapture will be realized by the liquidating corporation.

Taxpayers filing consolidated returns may defer this tax, namely, pay it over a period of time and not immediately in a partial liquidation. Nonetheless, the tax is still a liability on the corporation and it serves to reduce any future tax benefits that would otherwise be realized through depreciation deductions.

In summary, I would like to say that in a typical acquisition, taxes do not play the most important role in determining whether a deal is consummated. Rather, the first consideration is whether the transaction makes economic sense.

Here, the acquiring company looks at such factors as the price to be paid, return on investment, synergism with the business operations it already holds and potential for future growth among other factors.

If the transaction does not make sense at this level, it is typically aborted. Very few professionals would advise their clients to move forward on a transaction if the underlying economics did not make sense. If they did, such advice would seldom be followed by an astute business executive.

Finally, I would like to thank you for the opportunity of testifying at this hearing. In our judgment, the proposed legislation is founded on the assumption that tax attributes are the primary motivation for corporate takeovers.

We disagree with that assumption since it does not reflect the economic and business realities of the vast majority of corporate acquisitions.

[The prepared statement follows:]

STATEMENT OF EARL C. BROWN, ARTHUR ANDERSEN & CO.

SUMMARY

1. The proposed legislation appears to be based on the assumption that certain corporate acquisitions arise primarily from tax motivations. Our experience shows that tax attributes are but one of many considerations, including business compatibility, product lines, market penetration, vertical or horizontal integration and conglomerate diversification.

2. The proposed legislation is incorrect in its characterization of present law as permitting the same tax benefits to the buyer as a direct purchase of assets, without incurring the tax consequences to the seller of recognition of gain and recapture of depreciation.

3. Current tax law provides an economic disincentive to corporate acquisitions.

a. In acquisitions structured as nontaxable reorganizations, the purchaser almost never obtains any tax benefit for any cash paid, notwithstanding the fact that the selling shareholders pay tax on cash received in the transaction.

b. In acquisitions structured as taxable purchases, the acquiring corporation is unable to obtain any tax benefit for its purchase price unless a double tax is paid—the first a capital gains tax to the selling shareholders, and the second a recapture tax liability incurred by the acquired corporation.

4. The concept of capital recovery is in accord with established tax principles. Further, limitations on the ability to recover the cost of capital would discourage investment and contribute to economic stagnation.

5. The deferral of taxes in a consolidated return may give rise to perceived abuses. The proposal legislation is overly broad in attempting to correct that abuse, and ignores the fact that, over time, the deferred taxes are paid.

My name is Earl C. Brown, and I am a Partner, Head of Corporate Reorganization Tax Specialty Team, and Head of the Chicago Merger and Acqusitions Assistance Program for Arthur Andersen & Co. We welcome the opportunity to testify before this subcommittee today on the subject of the proposed "Corporate Takeover Tax Act of 1982," and related legislation.

Ours is an international accounting firm, with offices in major parts of the world. While we have many clients who would be affected by the proposals that will be considered, we do not represent them in this testimony and the views expressed are those of the firm itself.

Mr. Chairman, we have reviewed the Corporate Takeover Tax Act, and as well as H.R. 4562, H.R. 5517, H.R. 5719, and H.R. 5855. Our analysis suggests that these bills are all premised on the belief that the current activity in corporate mergers, acquisitions and reorganizations is becoming an abuse. These bills would all penalize these activities by denying deductions for expenditures in these transactions, by taxing the transactions themselves, or by completely revising the tax consequences of these transactions. We have two reasons for believing that enactment of any of these bills at the present time would be ill-advised.

GENERAL COMMENTS

First, H.R. 6295 amends only a few sections of Subchapter C. Even though the approach the legislation takes is broadbrushed and sweeping, we nonetherless believe that H.R. 6295 is only a piecemeal approach to the broader questions of the appropriate taxation of corporations and their shareholders. Thus, we believe that any major amendments to any part of Subchapter C should arise for a review of the entire Subchapter, and not just a few of its sections. If there are abuses, either real or perceived, they should be corrected, but not on a piecemeal basis.

Having noted that these bills treat one narrow aspect of a major section of the Code, we nonetheless believe that these bills, particularly H.R. 6295, are overly far-reaching in their attempts to correct a perceived abuse. The press release announcing these hearings suggests that the subcommittee is concerned that "an increasing number of corporate takeovers appear to be motivated by, or at least tailored to, the tax benefits which may be obtained under present law." Apparently, the subcommittee believes that these kinds of corporate activities arise exclusively from the motivation to derive tax benefits. We totally reject that assumption. Our testimony today will attempt to describe to the committee the economic motivations behind these activities, and the actual disincentives that occur in present law.

Among tax practitioners, the tax aspects of mergers, acquisitions, and reorganizations probably receive an undue amount of importance in the analysis of a transaction. Despite this tendency among practitioners, business people who plan transactions do not see the tax rules relating to corporate acquisitions as encouraging noneconomic mergers, acquisitions, or reorganizations.

The chief impetus behind virtually every corporate acquisition has consisted of a desire to acquire the business and/or assets of the acquired company, not the tax attributes. Competent business people are, and should be, cognizant of the tax aspects of various corporate transactions. If they are officers of the company, they have a legally imposed duty to the shareholders to safeguard the corporation's assets, so it is not unreasonable for them to be concerned with mitigating taxes. Nonetheless, those tax effects do not override the ultimate economic decisions to be made, which is whether the acquisition makes sense from a business standpoint.

A competent business planner contemplating an acquisition will consider such factors as business compatibility, product lines, market penetration, geographic proximity, vertical or horizontal integration, and conglomerate diversification. In today's market, we must consider interest rates. We cannot deny that tax attributes are also a factor in an acquisition, but they are only one of many factors, all of which should result in a sound economic transaction. Even if tax attributes, and not the desire to own the business or assets of the acquired company, were the primary motivating factors for the transaction, there are presently sections to the Code that deal with acquisitions where the principal purpose is to avoid taxes.

Therefore, the realities of business experience should teach us that the background and underlying assumptions upon which this proposed legislation is based are erroneous. The legislation presupposes a primary tax motivation for certain transactions and suggests that, but for the tax consequences, the transaction would not be consummated. We know of no substantial theoretical or statistical support for this position.

Rather, we believe that current tax law, on the whole, provides a disincentive for the average corporate acquisition. It certainly does not provide an overriding motive for takeovers for what would otherwise be "noneconomic" mergers and acquisitions.

PRESENT LAW DISINCENTIVES

The Internal Revenue Code currently provides for two basic types of corporate acquisitions, "tax-free" acquisitions under the reorganization provisions, and taxable acquisitions, which are often purchases that then are structured under the liquidation provisions of Subchapter C of the Internal Revenue Code.

The term "tax-free" acquisitions is really a misnomer. Simply stated, not all of the consideration received in a reorganization is tax-free. Rather, the only consideration (or payment) which is tax-free is stock or securities of the acquiring corporation. In a reorganization, shareholders of the acquired corporation may often receive millions of dollars in cash and pay significant tax on the cash received. In that same transaction, the acquiring company in the reorganization receives absolutely no additional tax basis in the assets it has acquired, even though it has paid, sometimes, millions of dollars of cash. Thus, it is clear that the current reorganization provisions may create a substantial economic disincentive to an acquisition if it is structured as a reorganization, since the acquiring corporation receives no additional tax basis, even though it may have spent substantial sums of money.

Taxable acquisitions can give rise to double taxation in certain integrated transactions. These two levels of taxation must be considered before the acquiring corporation can achieve a tax basis step-up in the assets of the acquired corporation. The first tax is paid by the shareholders of the acquired corporation. Whether the transaction is structured as an acquisition of the acquired corporation's stock or its assets, the shareholders of the acquired corporation will pay a tax, generally at capital gains rates, to the extent that they recognize gain in the transaction.

The acquired corporation incurs the second tax either in an asset acquisition or in a stock acquisition followed by the liquidation of the acquired corporation The tax arises because of the recapture of income and/or prior tax credits. In other areas, this committee has noted that double taxation is inappropriate. Similarly, the double taxation that arises in this instance actually provides a clear disincentive to corporate acquisitions. As a practical matter, we believe that the step-up in basis merely reflects the economics of the transaction. The purchaser corporation has, for valuable consideration, received the assets of the acquired corporation. A tax has been paid on recaptured items, so the new tax basis merely reflects the consideration the acquiring corporation has provided.

The concept underlying the ability of a corporation to allocate the purchase price of the stock of an acquired corporation to its underlying assets is essentially one of cost recovery. The concept of cost recovery is in accord with established tax principles. If corporation A wished to acquire a major grouping of assets, it could purchase those assets from, for example, a thousand vendors. Each of those vendors would receive some taxable income from the sale, and the purchaser, corporation A, would own an asset with a tax basis. In the interest of its own efficiency, however, corporation A may wish to acquire an entity that has already assembled the assets it wished to obtain. When an acquisition is thus reduced to its simplest economic terms, it is not unlike corporation A's acquisition of assets from a thousand vendors. Just as it can choose its method of assembling assets, so also should corporation A have the opportunity of choosing whether it will acquire those assets in either the tax-free or taxable transactions we have just described.

ANALYSIS OF TAX BENEFITS

The introductory remarks to H.R. 6295 and some of the publicity that has surrounded both the legislation and recent events in the marketplace seem to suggest a pervasive belief that corporate takeovers can be structured to achieve significant tax benefits. Recent publicity seems to suggest that takeovers can be structured so that the buyer receives the same tax benefits it would have had if it had purchased the assets directly, without incurring the tax consequence to the seller the recognition of gain and recaptured depreciation. Both the facts and the law underscore fallacies of these presumptions. A shareholder who sells his stock will recognize gain, assuming that the proceeds received exceed the adjusted tax basis of the stock sold. In point of fact, the tax on the gain paid by the selling shareholders may well exceed the present value of any future tax benefits to be received by the purchaser.

Additionally, under present tax rules, the tax consequences of depreciation recapture is not avoided. in the case of a stock purchase following by either a complete or a partial liquidation, depreciation recapture will be realized by the liquidating corporation. Taxpayers filing consolidated returns may defer taxes (i.e., pay over a period of time, and not immediately) in a partial liquidation. Nonetheless, the tax is still a liability of the corporation, and it serves to reduce any future tax benefits that would otherwise be realized through depreciation deductions.

This deferral of taxes in a consolidated return setting may give rise to perceived abuses. The committee should realize, however, that (1) income deferred is recognized (i.e., picked up as taxable income) as the acquired assets are depreciated or amortized and (2) if there is a subsequent divestiture of the acquired assets the divestiture will trigger payment in full of any remaining unpaid taxes. The proposed legislation would impose significant penalities on corporations that do not file consolidated returns, but who partially liquidate their assets. Thus, for example, a small business that had a fire at one of its facilities, and chose to liquidate that part of its business, rather than start up again, would be substantially penalized by these provisions. If the subcommittee feels that the deferral of taxes in a consolidated return environment carries the potential for great abuse, perhaps a way to curtail that abuse is to impose a financing charge of the deferral amount. Such a finance charge may be appropriate since, in many cases, there would not be a subsequent divestiture that would trigger payment of the deferred taxes.

CONCLUSION

We do not deny that a knowledgeable buyer and seller will typically scrutinize the tax attributes of the transaction. Indeed, the payment of taxes will be one of the factors considered in the negotiated purchase price. Again, however, we emphasize that tax attributes are not the primary motivation for mergers and acquisitions.

In a typical acquisition, taxes do not play the most important role in determining whether a deal is consummated. Rather, the first consideration is whether the transaction makes economic sense. Here the acquiring company looks at such factors as the price to be paid, return on investment, synergism with the business operations it already holds, and potential for future growth, among other factors. If the transaction does not make sense at this level, it typically is aborted. Very few professionals would advise their clients to move forward on a transaction if the underlying economics did not make sense. If they did, such advice would seldom be followed by an astute business executive.

As a matter of fact, from a practical standpoint, a major consideration in an acquisition is the impact the transaction will have on the acquiring corporation's financial statements. This is due to the fact that the accounting rules, in some measure, different from the tax rules dealing with corporate acquisitions. Often, an acquiring corporation has foregone a tax basis step-up in the target corporation's assets where to do so would have had an adverse impact on its earnings for financial reporting purposes.

Finally, we would like to thank you for the opportunity of testifying at this hearing. In our judgment, the proposed legislation is founded on the assumption that tax attributes are the primary motivation for corporate takeovers. We disagree with that assumption since it does not reflect the economic and business realities of the vast majority of corporate acquisitions.

We believe the issues these bills address are nonetheless significant ones, but urge the subcommittee to act on them only after it has reviewed all of Subchapter C. If such an extensive review is not feasible, we urge the committee to avoid hasty and overly broad legislation in this intricate area of the Code.

STATEMENT OF MICHAEL J. McCORMACK, PARTNER, DELOITTE, HASKINS & SELLS

Chairman **Stark**. Mr. McCormack.

Mr. **McCormack**. Thank you, Mr. Chairman.

I share the view expressed by some of the previous witnesses that our tax laws regarding taxable acquisitions should be made as neutral as possible in the decision process.

This afternoon I would like to briefly, however, outline some possible unintended results of this bill which seems or would appear to be contrary to its stated purposes.

As I understand it, the stated purposes for the new provision is to give symmetry of treatment to asset and stock purchases in corporate acquisitions. I believe, however, that the bill as drafted has a far greater impact than the stated purposes. Indeed, H.R. 6295 in its present form would present business and administrative problems and have a major impact on small and closely held businesses.

In addition, as has been previously stated, the bill extends the concept of double taxation, that is, taxation at both the corporate and shareholder level beyond the normal earnings of the corporation to the appreciation in the assets of the corporation.

To be brief, I will limit my remaining testimony to the effect of the legislation on small businesses and the effect of the proposed effective step-up provision, which has been previously referred to as the selectivity issue.

The point on small business might best be illustrated by the following example: The example would involve a family corporation owned by two brothers which has been operating for many years. For various reasons, the two brothers decide to split the business and operate separately by districting a part of the business to one of the brothers in redemption of all of his outstanding stock.

Under the proposed amendment the corporation would have to pay a tax on the entire appreciation in value of the assets distributed and, in addition, the redeemed brother would be taxed on the capital gain realized upon the receipt of those assets. In other words, taxation has occurred at both the corporate and shareholder level.

Under present law, the redeemed brother would pay his full capital against tax but at the corporate level the family company would only be liable for recaptures.

Although one of the purposes of the bill is to disallow movement of assets without the imposition of recapture taxes and although this transaction just described does not frustrate that policy, nevertheless, it is covered in the bill. More ironic, perhaps, is the fact that if the company completely liquidated and split up all of its assets between the two brothers who thereafter operated in proprietorship or partnership form there would be no corporate level tax other than recaptures.

I perceive no tax policy reason for a partial liquidation or a redemption to be subject to double tax while a complete liquidation under these circumstances receives different treatment. Such a statute effectively puts an unnecessary burden on tax planning since if, under the statute, the two brothers had the foresight to have split their company 5 years previously, no double tax would be present.

I have a further example on the small business aspects which is in my prepared statement.

The second issue I would like to take up is the selectivity issue. This issue arises because of the repeal of section 334(b)(2), the modification of the traditional section 337 statute, and the replacement of those provisions with the elective provision.

While I feel that some type of an elective provision might be appropriate, by tying the elective provision with an all-or-nothing approach, certain hardships will result and business decisions will clearly be interrupted.

The practical effect of this provision will be to make income tax ramifications the prime concern in both acquisition situations and in transactions designed to provide for more efficient business operations rather than making the income tax considerations neutral.

The antiselective election provisions of the bill might best be illustrated by the following example: Assume a target company which I will refer to as T, has five first year U.S. subsidiaries, one of which happens to be a savings and loan and another of which happens to be an insurance company. In addition, one of its first tier subsidiaries has a series of lower tier foreign subsidiaries, one of which might happen to be a disc.

Under existing law, an acquiring purchaser, which I will refer to as P, would acquire all of the outstanding stock of T, completely liquidate T, and obtain basis with respect to the assets of T at a cost of triggering the recapture inherent in those assets. Once this transaction was consummated, P would have a stepped-up basis in the stock of the five subsidiaries received upon T's liquidation but the basis of the assets in those subsidiaries would, at this point, be unchanged. Furthermore, any recaptures would have been solely those relating to the assets held by T.

Under the proposed legislation in this same acquisition, P would, within 60 days of the close of the acquisition period, have to make an election to step up the basis of the assets of T. If this election were made, however, and without any transfer taking place, all of T's lower tier subsidiaries would be bound by the election. Therefore, by making the election, T would effectively trigger all recaptures within the entire group including recaptures of depreciation, investment credit, the bad debt reserve of the savings and loan, the insurance reserves, that is, phase three tax on the insurance company, the DISC income and all of the unrepatriated foreign earnings.

Such an elective statute certainly would have a practical effect of discouraging all acquisitions. Moreover, the buyer in all likelihood would not be in a position at the time the election would have to be made to analyze the transaction to a sufficient extent to know whether the election should or should not be made.

Chairman STARK. Why would he not make that before he even bought the company?

Mr. MCCORMACK. Mr. Stark, one of the problems that I envision is the 60-day period, although I don't fully understand when that period starts. If it is 60 days after—

Chairman STARK. That is sort of trying to find out whether your mare is pregnant after you buy her, isn't it?

Mr. MCCORMACK. That's right.

If it is 60 days after one acquires the 80-percent stock ownership and that is the deemed date of the transfer, I would feel that that probably is not enough time to make a full analysis. If it is further than that? If it is a year after the acquisition and the transfer then is deemed to take place the previous year, we have problems then with estimated taxes and the returns being due on time. So I guess I have not fully figured out under this bill exactly how those provisions would interrelate.

More important, however, would be the possibility that in these lower tier subsidiaries, there were loan agreements and restrictive net worth covenants. Although it is not clear under the bill who bears the brunt of the taxes when the election is made, certainly it is not inconceivable that a subsidary's net worth indenture requirements could be violated and the subsidiary thrown into default on its indenture issues.

This all-or-nothing election is applicable irrespective of whether the group actually files a consolidated return for Federal income tax purposes. It also applies even if there is up to a 20-percent unrelated minority interest in the subsidiary.

Under these circumstances, it would seem unfair and would appear to violate fundamental rules of taxation to allow one party's action to create a tax liability for another when the other party has not participated in a taxable transaction.

In closing, I would just like to emphasize that the bill would have a significantly greater impact on transactions unrelated to those the legislation is supposed to effect and, moreover, rather than reaching the stated intention of making the tax laws a neutral factor in corporate acquisitions, portions of the bill would reach the opposite result.

Thank you, sir.

[The prepared statement follows:]

STATEMENT OF MICHAEL J. MCCORMACK ON BEHALF OF DELOITTE, HASKINS & SELLS

My name is Michael McCormack and I am a partner in the international public accounting firm of Deloitte, Haskins & Sells. We appreciate this opportunity to present our views on "The Corporate Takeover Tax Act of 1982" introduced by the Chairman of this Subcommittee.

The bill introduces an entirely new concept to the rules governing the taxation of a corporation acquired in a taxable transaction. It will generally impose a tax at the corporate level on all appreciated property distributions in redemption of stock if the distribution is not in complete liquidation of the corporation. More specifically, the bill either repeals or amends sections 302, 311(d), 331, 334(b)(2), 336, 337, and 346, and substantially modifies the consolidated return regulations.

The stated purpose for the new provisions, as reflected in Mr. Stark's statement on the House floor (Congressional Record, May 6, 1982), is to give symmetry of treatment to asset and stock pruchases in corporate acquisitions. We believe that the bill as drafted has a far greater impact than the stated purpose. For this reason, and because any currently perceived inequities could be rectified by amending existing Treasury regulations, we oppose the enactment of the bill in its present form.

Our opposition, as is more fully explained below, is founded upon the view that the present law which has developed over many years works rather well in the vast majority of cases; whereas, the bill would present serious business and administrative problems and have a major impact on small and closely held businesses. In this regard, I would like to point out that while the bill requires the Secretary to promulgate no less than 10 legislative regulations most of its provisions are effective September 1, 1982. In addition the bill does not represent sound tax policy since it extends double taxation; that is, taxation at both the corporate and shareholder level beyond the normal earnings of the corporation. Given the time restraints imposed upon the submission of comments on this bill, I will limit my testimony today generally to the effect of the legislation on small businesses, the effect of the legislation on all businesses of the adoption of the proposed elective step-up provisions, and certain miscelleanous provisions of the bill.

SMALL BUSINESS IMPACT

Although the stated purpose for this legislation is to correct some perceived inequities resulting from the use of a partial or delayed complete liquidation, and from purchases of stock followed by its immediate redemption for appreciated property, the bill as drafted is much more far reaching. In an attempt to correct these perceived inequities, the bill repeals sections 334(b)(2) and section 346, amends section 337 and eliminates most of the provisions which exempt from taxation any corporate gain upon distributions in redemption of stock under sections 311 and 336 of the Code.

It should be noted at the outset that most of these provisions have been traditionally used by small businesses to restructure their business activities and to allow corporate acquisitions to be consummated under clearly defined tax rules.

The repeal of sections 311 and 346 will have the greatest impact on small businesses. Section 311 provides that as a general rule a corporation will not recognize gain on the distribution of appreciated property with respect to its stock. In 1969 the statute was amended to trigger appreciation in instances where the redeemed shareholder had not been a substantial shareholder (i.e. held a 10 percent interest) for at least a year, or where the property distributed was the stock of a subsidiary which did not have a substantial history of ownership by the distributing company. The bill repeals most of the exceptions to gain recognition under section 311 and also repeals the provisions of section 346, dealing with partial liquidations of corporations.

Under this latter section, a corporation making a distribution of appreciated property in redemption of its stock would, if the distribution qualified as a partial liquadation, currently be protected from the recognition of gain. Under the bill this same protection would only be afforded in complete liquidations with certain exceptions.

The bill would retain capital gain treatment at the shareholder level only for the distribution of assets constituting and active trade or business with a five year history, and would impose a double tax because neither the modified section 336 nor the retained exceptions under section 311 would protect the distributing corporation from tax. Ironically, if this bill is passed, a single business may be split-up and distributed in corporate form to the shareholders of the distributing corporation tax-free under section 355, but the distribution of the underlying assets by the distributing corporation in redemption of a portion of its stock may not even qualify for capital gains treatment at the shareholder level and will result in gain and recapture at the corporate level.

As I previously stated, the proposed legislation will most directly affect closely held family corporations. This point may be illustrated by the use of the following simple examples.

The first example would involve a family corporation owned by two brothers which has been operating for many years. For various reasons the two brothers decide to split the business and operate separately by distributing a part of the business to one of the brothers in redemption of all of his outstanding stock. Under the proposed amendment, the corporation will have to pay a tax on the entire appreciation in the value of the assets distributed and, in addition, the redeemed brother will be taxed on the capital gain realized upon the receipt of the assets. In other words, taxation has occurred at both the corporate and shareholder level. Under present law the redeemed brother would pay his full capital gains tax but at the corporate level the family company would only be liable for statutory recaptures.

Although one of the stated purposes of the bill is to disallow a movement of assets without the imposition of recapture taxes, and although this transaction should not frustrate that policy, nevertheless it is covered by the bill. More ironic, perhaps, is the fact that if the company compeletely liquidated and split up all its assets between the two brothers who thereafter operated in proprietorship or partnership form, there would be no corporate level tax other than recaptures. We perceive absolutely no tax policy reason for a partial liquidation or a redemption to be subject to a double tax while a complete liquidation receives different treatment. Such a statute puts a unnecessary burden on tax planning since if, under this statute, the two brothers had the foresight to have split up their company five years previously, no double tax would be present. Consequently, the practical effect of the provision is to either discourage the operations of business in corporate form or to encourage a complete disposition of the family business—neither of which effects is relevant to corporate takeovers.

Another example of the affects of the bill unrelated to corporate takeovers relates to the sale of a family business to the children of the present shareholders. Assume a father, who founded a business and owns all of the stock, wishes to sell it to his children who are active in the business. Assume further, however, that the children cannot afford to purchase the entire business because the real estate on which the corporation operates its business has vastly appreciated. In order to finance the sale of the family business to the children present law would permit the corporation to distribute the real estate to the father in redemption of a portion of his stock without a corporate level tax (except for recapture). The father of course would pay tax on the appreciation in the value of his shares. The father then could sell his remaining shares to the children at an affordable price. If this legislation is enacted, this financing method would result in a double tax on the distribution. The corporation would be fully taxed on the appreciation in the real estate and the father in the appreciation in his shares. Consequently, there will be a serious tax impediment to the practical needs of the family business.

THE NEW ELECTION CONCEPT

The bill also repeals the provisions of section 334(b)(2) and modifies the provisions of section 337. These provisions have given taxpayers certainty in planning acquisitions for the past 28 years. The central element of the bill is that it replaces the traditional step-up rules with a provision whereby one must elect to step up the basis of assets. However, the election provided in the bill does not permit a step up in the basis of only selected assets. In other words, if one is to receive a step up in the basis of any assets of an acquired company and its subsidiaries, all of the assets in the group must be stepped up, and full recapture taxes paid with respect to all those assets. The practical effect of this provision will be to severely curtail acquisition activity—both in takeover situations and in transactions designed to provide for more efficient business operations.

The requirement that an election be made with respect to all of the assets of the acquired group will, in many instances, result in the transaction not being consummated or, if its consummated, in the price which the purchaser is willing to pay being greatly reduced.

For instance, assume that a target company directly owns a prime manufacturing site which has greatly appreciated in value but upon which there is little or no recapture. In addition, assume that the company owns a subsidiary engagement in manufacturing which as a large amount of potential recapture. Although a purchase might be interested in acquiring solely the real properties for cashing order to open a new plant, the target company may well not be interested in selling just those assets since to do so would probably trigger a large taxable gain. In order to avoid that gain, the target company would have to distribute the shares of its subsidiary to its shareholders, an act which would (under at least one interpretation of the bill) trigger the recaptures in the subsidiary. This would be the case notwithstanding the fact that the business of the subsidiary remained unchanged and was operated by the former shareholders of its parent corporation.

If the purchaser, on the other hand, purchased the entire affiliated group, it would have to decide whether to forego a cost basis with respect to the real property or pay the "toll charge" with respect to the assets of the subsidiary.

The election provisions of the bill will also present severe hardships. For example, assume a target company (*T*) has five first tier U.S. subsidiaries, one of which is a savings and loan and one of which is an insurance company, and those subsidiaries in turn have five additional subsidiaries, four of which are foreign corporations and one of which is a DISC. Assume the target company, itself, also operates a business. Under existing law, an acquiring purchaser (*P*) could acquire all of the outstanding stock of *T* completely liquidate *T* and obtain a step-up in basis with respect to the assets of *T* at the cost of triggering the recapture inherent in those assets. Once this transaction was consummated, *P* would have a stepped-up basis in the stock of the five subsidiaries received upon *T*'s liquidation, but the basis of the assets of those subsidiaries would, at this point, be unchanged. Furthermore, any recaptures would have been solely those relating to the assets held by *T*.

If *P* later wished to obtain a step-up in basis of the assets of one or all of the lower tier subsidiaries, it could then completely liquidate those subsidiaries, obtain a step-up in basis and, at that point, it would trigger any recaptures inherent in the assets transferred. Under the proposed legislation, *P* would within 60 days of the close of the "acquisition period" have to make an election to step-up the basis of the assets of *T*. If this election were made, however, and without an transfer taking place, all of *T*'s lower tier subsidiaries would be bound by the election. Therefore, by making the election, *T* would effectively trigger all recaptures within the entire *T* group including recaptures of depreciation, investment credit, bad debt reserves, insurance reserves, DISC income, and all 1248 foreign earnings—all in order to obtain the step-up ot T's assets. Such a statute certainly will have the practical effect of discouraging all acquisitions.

Moreover, the buyer, in all likelihood, would not be in a position by the time the election would have to be made to have analyze the transaction to a sufficient extent to know whether the election should or should not be made. In addition, the buyer would generally have little or no idea how much the acquisition would actually cost since, in order to make an intelligent estimate of the cost of the acquisition, all of the assets in the group and operations would have to be analyzed, the insurance and savings and loan ramifications would have to be analyzed, appraisals on all of the assets of the company would have to be secured, and possibly foreign earnings and profits studies made.

In addition loan covenants and agreements of the subsidiaries would also have to be analyzed. In this regard, it is not uncommon for members of a group to be under net worth restrictions with respect to loan covenants. If an election at the parent level will, in fact, trigger a liability on that subsidiary, it is not inconceivable that the subsidiary's net worth indenture requirements could be violated and the subsidiary thrown into default on its indenture issue.

This all-or-nothing election is applicable irrespective of whether the acquired group actually files a consolidated return for Federal income tax purposes if the stock ownership requirements are met. It also applies even though there is up to 20 percent unrelated minority stock interest in the subsidiary. Under these circumstances, it seems unfair, and would appear to violate the fundamental rules of taxation, to allow one party's action to create a tax liability for another, when the other party has not participipted in a taxable transaction. For the same reason, and because of possible debt covenants at the parent level, it woud also seem unfair to impose the entire recapture on the parent company as a result of the election.

This bill apparently intends to modify existing section 337 to conform with the "elective" treatment discussed above. However, as drafted, the bill does not achieve that parity. As drafted, the modifications to existing section 337 apply only to complete liquidations under 332. The difference can be illustrated in the following example.

A parent corporation adopts a plan of liquidation and sells its assets, other than stock of its subsidiaries, liquidates and distributes the sales proceeds and subsidiary stock to its shareholders. Since the liquidation does not qualify under section 332, there is no requirement that all members of the affiliated group be liquidated in order to be afforded section 337 protection. However, if section 337 protection is desired with respect to the sale of only the assets of a subsidiary, then recapture would apply with respect to all assets of the affiliated group since all members of the group would have to be liquidated.

ADDITIONAL COMMENTS

Another distrubing provision of this bill is the limitation put on the no gain or loss provisions of section 336 in a complete liquidation where the liquidating corporation has been the transferor corporation in a section 351 transaction or the distributing or controlled corporation in a section 355 transaction within a five-year period of the liquidation. This rule assumes that any transfers of assets within this period are, per se, an attempt to tailor the liquidating corporation's assets to avoid recapture. This provision imposes a burden on a company of kowing whether it might be in its best interest to liquidate within any succeeding five-year period before it makes what otherwise would be notax motivated decisions made in the ordinary course of its business. This rule applies even to transfers of nonrecapture property. Moreover, there is no provision in the bill to allow a taxpayer to undo previous transfers if the need arises. Such a strict rule would have the practical effect of making any affiliated group of corporations liquidation-proof. Since this provision is to be effective to liquidating distributions made after Ausust 31, 1982, and since the bill does not provide any grandfather clause for section 355 or 351 transactions which have already occurred, transactions made before the introduction of this bill would preclude section 336 protection in a subsequent liquidation.

CONCLUSION

The present tax law with respect to acquisitions has developed over mnay years, and the variety of transactions have at least become well-known and consistently applied.

In the vast majority of cases these rules work rather well. Any perceived inequities resulting from the use of partial or delayed complete liquidations within a consolidated return setting are, if warranted, easily rectified by amending existing regulations—something the Secretary already has the authority to do. In addition, transactions in which stock is purchased and immediately redeemed with appreciated property are already covered by existing case law. This being the case, there does not appear to be any need for the legislation as presently proposed. If Congress decides it must act, we suggest it go slowly and only after allowing responsible professional organizations an opportunity to thoroughly study the issues.

As discussed above, this bill would have a very significant far greater impact on transactions unrelated to those the legislation is supposed to affect. Such is the likely result from any legislation that attempts to regulate corporate acquisitions through our tax laws. For this reason we do not believe that the Internal Revenue Code should be used as a regulatory device to control corporate takeovers. Rather than reaching the stated intention of making the tax laws a neutral factor in corporate acquisitions, this bill would reach the opposite result by making the income tax ramifications the paramount consideration in corporate acquisitions as well as legitimate corporate restructurings.

Thank you for the opportunity to express these views on this important subject.

STATEMENT OF GILBERT D. BLOOM, PARTNER, PEAT, MARWICK, MITCHELL & CO.

Chairman STARK. Mr. Bloom?

Mr. BLOOM. Thank you, Mr. Chairman.

My name is Gilbert Bloom, a partner in the national tax office of Peat, Marwick & Mitchell, Washington, D.C. I appreciate the opportunity to present testimony on H.R. 6295—The Corporate Takeover Tax Act of 1982—on behalf of the international accounting firm of Peat, Marwick, Mitchell & Co. This bill would make the most profound changes in subchapter C of the Internal Revenue Code in 28 years and would overturn principles established in the 1930's. Therefore, these proposed changes warrant very careful study and analysis. However, since there has been only a 10-day period from the availability of this bill until written comments were due, my comments today can only be broad preliminary observations.

It is respectfully submitted that title I is antismall business and an overkill to the problem at hand. Title I would repeal capital gain treatment to shareholders in the innocuous situations involving distribution of proceeds of sale or business assets between corporations and their shareholders. Title I would also impose a tax on corporations in virtually all distributions in redemption or what is now a partial liquidation and would overturn a 50-year-old principle and congressional policy.

Taxability will accrue to the corporation regardless of how long the assets were held, regardless of whether the assets represent an active trade or business, regardless of the business reasons for the distribution and regardless of the existence of a corporate takeover.

It will, as advertised, thwart the transactions contemplated by the drafters. However, we believe that the major impact of this bill will fall on small- and medium-size corporations and their shareholders. It would have little impact on large corporations which rarely make property distributions in redemption or partial liquidation.

It would place a very heavy toll on the countless number of legitimate transactions which are not involved in takeover situations.

The perceived abuse could, however, be corrected without jeopardizing the numerous nontakeover, nontax motivated transactions. Title I could be replaced with two changes to existing law.

One, Congress could provide for the same recaptures on a partial liquidation, regardless of when the distribution is made, as are now provided for in a complete liquidation under section 334(b)(2). This similarity of treatment would take place even if a consolidated return is filed.

And two, a corporate tax could be imposed on any non-pro-rata distribution in redemption or partial liquidation where the recipient shareholder has not held the common stock of the corporation for a fixed period of time. For example, 1 or 2 years.

With these changes in place, the main objectives of H.R. 6295 as stated in the explanation to the bill would be achieved. That is, no "avoidance of gain recognition on what is in substance a sale of assets" and no "availability of a basic step up without current taxation of recapture income and without investment credit recapture."

Title II, providing for a deemed step-up in basis without an actual liquidation is an interesting concept. Existing law places a heavy premium on the correct corporation making the purchase of stock under section 334(b)(2). There are also many State, contractual, and business impediments which preclude an actual liquidation. Therefore, the concept of a deemed step-up in basis is desirable.

However, we question the underlying premise for this new code section. Under title II, net operating losses and other attributes would immediately be eliminated after the election for a step-up in bases is made. The reason for this rule is stated in explanation to H.R. 6295 as the ability to achieve a step-up in basis after a delayed liquidation and in the interim use the loss and credit carryforwards of the acquired corporation on the acquiring corporation's consolidated return. The losses of the acquired corporation cannot be offset against the acquiring corporation's income.

Under the existing rules, they are limited by the so-called SRLY rules of the consolidated return regulations and can only be used against the future income of the acquired corporation.

Moreover, any delay in the liquidation of the acquired corporation will in a number of situations have detrimental effects for the corporations by the loss of depreciation and resulting basis in the assets. The former by the failure to depreciate at a higher figure and the latter by the hypothetical earnings and profits rules of the regulations under section 334(b)(2). Thus, we see no abuse in this area under current law.

Title III would change the rules under section 382 pertaining to the survival of net operating losses. In 1976, section 382 was revised but through continuous deferral has not yet gone into effect.

The 1976 law was harsh, complicated and was enacted without hearings. We question the need for title III. It would not only resurrect the principles of the 1976 law but would be even more restrictive since it would require either a 60-percent continuity of interest or a pro tanto scaledown of losses.

Title III would prevent legitimate turnaround situations where a corporation with losses is denied these losses against future income. This problem is particularly acute today because of current economic conditions. Losses will disappear when there is an influx of new investors in a rehabilitation attempt. As to the weakness to the companies this legislation would be another impediment to survival.

In conclusion, we believe that H.R. 6295 as currently drafted is not needed and would have a debilitating effect on many nontakeover situations. Perceived abuses in title I can be corrected with a less ambitious but equally effective approach. We question the premises and the need for action in title II and title III.

Thank you, Mr. Chairman.

Chairman STARK. Thank you very much.

[The prepared statement follows:]

STATEMENT OF GILBERT D. BLOOM ON BEHALF OF PEAT, MARWICK, MITCHELL & CO.

My name is Gilbert D. Bloom, a partner in the National Tax Office of Peat, Marwick, Mitchell & Co., Washingtion, D.C. I appreciate the opportunity to present testimony on H.R. 6295 (Corporate Takeover Tax Act of 1982) on behalf of the international accounting firm of Peat, Marwick, Mitchell & Co. This Bill would make the most profound changes in Subchapter C of the Internal Revenue Code in 28 years and would overturn principles established in the 1930's. Therefore, these proposed changes warrant very careful study and analysis. However, since there has been only a ten-day period from the availability of this Bill until written comments were due, my comments today can only be broad preliminary observations.

Title I would repeal capital gain treatment to shareholders in the case of distributions in partial liquidation including: (1) the distribution of insurance proceeds from the destruction of all or part of a business conducted for more than five years where the remaining business has been conducted for less than five years; (2) the distribution of the assets of a business conducted for more than five years, which is to be operated by the shareholders in partnership form, where the ramining business is less than five years old; and (3) the partial redemption of a large shareholder, for example a 90 percent shareholder, with part of an active business where such shareholder continues to own over 50 percent of the stock of the corporation. This last transaction may be motivated by a desire to reduce the value of the company, to permit key employees to purchase shares at a lower price, or to encourage gifts to family members in the business; alternatively, such a distribution may be made to resolve acrimonious disputes.

The ability of corporations to distribute property in redemption or partial liquidation without incurring a corporate tax goes back to the 1935 Supreme Court case of *General Utilities and Operating Co.* v. *Helvering,* 296 U.S. 200 (1935), which was codified in 1954. Although Congress and the courts have developed a number of exceptions to nonrecognition treatment, the most significant of which was codified in 1969, tax free treatment has generally remained intact for a significant number of commercially desirable, business motivated, nontakeover situations. All this will change under the proposed Corporate Takeover Tax Act of 1982. The stated need for these new provisions is to thwart the corporate sale of assets via a redemption or partial liquidation which avoids investment credit and depreciation recapture. However, the proposed remedy to the perceived abuses will unfairly impact a multitude of nontakeover situations.

The generally pervasive rule of nontaxable treatment to the corporation would, if this Bill is enacted, give rise to ordinary income or capital gain depending on the type of assets distributed in redemption or partial liquidation. However, no loss would be recognized. These results would accrue to the corporation regardless of how long the assets were held, regardless of whether the assets represent an active trade or business, regardless of the business reasons for the distribution, and regardless of the existence of a corporate takeover. While it would thwart the corporate "sale" of assets via a redemption or partial liquidation and provide for recapture of investment credit and immediate recapture of depreciation where a purchase of stock is made as a prelude to a desired step-up in the basis of the assets, we believe that the major impact of this Bill would fall on small and medium-sized corporations and their shareholders. It would have little impact on large corporations which rarely make property distributions in redemption or partial liquidation. This, the few "abusive" transactions would be stopped but at a cost of placing a very heavy toll on the countless number of legitimate transactions which are not involved in "takeover" situations.

The perceived abuse could, however, be corrected without jeopardizing the numerous nontakeover, nontax motivated transactions. Title I could be replaced with two changes to existing law. One, Congress can provide for the same recaptures on a partial liquidation (regardless of when the distribution is made) as are now provided for on a complete liquidation under section 334(b)(2). This similarity of treatment would take place even if a consolidated return is filed. Two, a corporate tax could be imposed on any nonpro rata distribution in redemption or partial liquidation where the recipient shareholder has not held common stock of the corporation for a fixed period of time (e.g., one or two years.) With these changes in place, the main objectives of H.R. 6295, as stated in the explanation to the Bill, would be achieved, i.e., no "avoidance of gain recognition on what is in substance a sale of assets" and no "availability of a basis step-up without current taxation of recepture income and without investment credit recapture."

Title II would replace section 334(b)(2) with new Code section 338 and provide for a deemed step-up in basis without an actual liquidation. This is an interesting concept. Existing law places a heavy premium on the correct corporation making the purchase of stock under section 334(b)(2). There are also many state law, contractual, and business impediments which preclude an actual liquidation. Therefore, the concept of a deemed step-up in basis is desirable. However, we question the underlying premise for this new Code section. Under Title II, net operating losses and other attributes would immediately be eliminated after the election for a step-up in basis is made. The reason for this rule is stated in the explanation to H.R. 6295 as follows:

"This treatment [basis step-up] is available even though the plan of liquidation need not be adopted until 2 years after the qualifying stock purchase and the liquidation need not be completed for an additional 3 years. In the meantime, the acquired company's tax attributes, such as loss and credit carry-forwards, can be used on the acquiring company's consolidated return * * *."

It should be noted that losses of the acquired corporation cannot be offset against the acquiring corporation's income. Under the existing rules, they are limited by

Regulations Section 1.1502-21(c), the so-called separate return limitation year (SRLY) rule, and can be used only against the future income of the acquired corporation. Thus, there is no offsetting of the acquiring corporation's income against the acquired corporation's losses. Moreover, any delay in the section 334(b)(2) liquidation of the acquired corporation will in a number of situations have detrimental effects for the corporations by the loss of depreciation and resulting basis of assets; the former by the failure to depreciate at a higher figure, the latter by the hypothetical earnings and profits rules of the regulations under section 334(b)(2). Thus, we see no abuse in this area under current law.

Title III would change the rules under section 382, pertaining to the survival of net operating losses. In 1976, section 382 ws revised but through continuous deferral has not yet gone into effect. The 1976 law was harsh, complicated, and was enacted without hearings. We question the need for title III. It would not only resurrect the principles of the 1976 law but would be even more restrictive since it requires either a 60 percent continuity of interest or a pro tanto scale down of losses. Title III would prevent legitimate "turn around" situations where a corporation with losses is denied these losses against future income. This problem is particularly acute today because of current economic conditions. Under Title III, the losses will disappear when there is an influx of new investors in a rehabilitation attempt. As to the weakest companies, this legislation would be another impediment to survival.

Finally, the revision to section 368(a)(1)(F) seems inappropriate in this Corporate Takeover Tax Act. Certainly, an "F" reorganization requires a commonality of shareholder interest. New shareholders will prevent a corporation from qualifying a reorganization under section 368(a)(1)(F). Where a corporation has the ability by divisional accounting to ascertain a post-acquisition loss, it should be able to carryback that loss to a pre-acqusition year. This is merely the matching of income and loss by the same corporation. The courts and the Internal Revenue Service have agreed that this is proper.

In conclusion, we believe that H.R. 6295, as currently drafted, is not needed and would have a debilitating effect on many nontakeover transactions. Perceived abuses can be corrected with a less ambitious, but equally effective, approach.

Chairman STARK. Thank you very much.

Mr. Brown, in your testimony, you suggested that acquiring companies look [illegible] variety of practices, price, return on investment, synergism [illegible] growth—I suppose expansion. I guess it hasn't been mention[illegible]ch and really this bill wouldn't apply to it, but let's take Un[illegible]es Steel and Marathon.

Obviously, [illegible] no synergism, and all that United States Steel is int[illegible]s one large pool of oil. Probably there isn't any future [illegible]. There is as much oil down there as there is going to be. They aren't going to make anymore of it down there. So you are dealing with merely the price paid and returned on investment in situations like that, aren't you?

Mr. BROWN. Sir, you are relating to any conglomerate.

Chairman STARK. Now, your buying an asset has nothing to do with the business you are buying. It is an investment.

Mr. BROWN. It is an investment. It is diversification, which occurs in many conglomerates today.

Chairman STARK. I don't quarrel with that. I just want to narrow down here. That is another typical acquisition that only generally relates to the price you pay and the return you are going to get. Now would you tell me that there aren't a whole lot of different earning investments out there that a corporation could buy or could acquire in different ways, where the tax effect of the structure and the nature of the asset would make a very big difference on the return on investment?

Mr. BROWN. The tax effect often will have an influence on the return on investment, depending on which way it is accomplished.

Our experience is that in most instances the deal is made before taxes are ever considered.

Chairman **Stark**. What I am getting at is, let's just assume that I own a pool of oil someplace under the ground and a foundry wants to buy it from me. Let's also say, on the other hand, that a department store would like to buy it from me. Why shouldn't they just want to buy it from me? Why should the taxpayers make it more attractive for them to buy it from me through some complex "Tinkers to Evers to Chance" corporate gimmickry instead of just paying cash for it, and then they have got their oil pool and I pay my capital again?

What is the overriding economic, social, patriotic value in letting the taxpayers help me sell my pool of oil to either whoever happens to have the most creative lawyers and CPA's?

Mr. **Brown**. I think that, with your indulgence, any time that you pay cash for any asset, whether it is another machine or what have you, the present tax law allows you to amortize that investment in some way against your income to be realized from that investment, so that here an acquisition is merely acquiring a thousand pieces of equipment, for example, all in one company, instead of buying them one at a time.

Now, whether they are related exactly to the one business that you made reference to, that is an entirely different question. Many companies find it desirable to diversify, in order to avoid the roller-coaster effect on their stock price. Certain businesses are cyclical and seasonal, and so on.

Chairman **Stark**. No quarrel from me. I just want to get back to that question. Why should the taxpayers of this country bear part of that burden? Why should they do it?

Mr. **Brown**. I think that it is a fundamental principle in our tax law that any time you pay cash for a particular asset, you acquire tax basis in that asset, which, since it is going to produce income for you, you should be entitled to amortize the investment cost against the income.

Chairman **Stark**. Why should there be any difference if you buy it? Let's say we have decided which ones would be better under the law, under God, and under motherhood. Let's say we decide company A ought to be it. Why, when we have decided that, should you make more money doing it?

Why should the taxpayers have to give a bigger subsidy to the acquiring company under one structure than under another?

Mr. **Brown**. Sir, except for the couple of items that Mr. Bloom related to, that doesn't occur. If you do a complete liquidation, you pay all the taxes that are normally paid. The shareholder pays the tax. The corporation pays the tax. There is one situation that I am familiar with where there is a deferral that occurs in the consolidated return, and that only happens on what is called a partial liquidation. Other than that——

Chairman **Stark**. You don't think that there is any difference in the tax treatment between direct purchases and stock redemptions? The substance of the transaction is the same. Now, why should the form of the transaction control the tax consequence, when the substance is the same? You just have company A acquiring a pool of oil. Why should the gimmickry, the way you shuffle the papers around at the closing of the escrow, determine the level of taxes to be paid?

Mr. **Brown**. I don't think it does. I do think that when you acquire the stock of a company, sir, the principle is that you are really acquiring the assets, so the law is designed to attempt to allow you to treat it as if you had acquired the asset.

Chairman **Stark**. Yes, but if in fact what I am telling you is the case—since you have bright enough accountants and attorneys, to acquire an asset from a corporation, and by the time you are done—then nobody pays any tax.

Now, why should you be able to structure that, when normally the sale of the asset by the owner would cause a capital gain or perhaps ordinary income recapture, if they had acquired some of this asset by depreciation?

This committee has no interest in controlling mergers per se. It is just a question of where you can materially change the tax consequences of otherwise perfectly reasonable, normal business transactions. It doesn't seem quite proper. Indeed, where the tax consequence can seem to drive the transaction, it seems a waste of good taxpayers' money.

Mr. **Brown**. I would not disagree with you. In my experience, which has been over 30 years, I have not seen a situation where, in an acquisition, you end up not paying any tax.

Chairman **Stark**. You have not seen an acquisition transaction where the tax consequences were the material incentive for facilitating it, without the tax consequences, it would have been an uneconomic transaction? Have you ever seen one like that?

Mr. **Brown**. I have seen situations where without the ability to get a deduction for the investment through the savings of tax, the investment would have not been economic, but I submit that that is true any time you pay hard cash for any asset. You have got to be able to recover your cost against your income.

Chairman **Stark**. How about recover more than your cost?

Mr. **Brown**. I am sorry, I do not see how you can recover more than your cost. The law is pretty clear about limiting you to your basis.

Chairman **Stark**. Accelerated cost recovery, in some instances on certain life assets. It gives you back more now but there were some classes of assets where you get 110 percent before ACRS.

Mr. **Brown**. ACRS gives you your cost back.

Chairman **Stark**. Plus.

Mr. **Brown**. Well, the only plus I can think of is investment tax credit.

Chairman **Stark**. You don't think that is part of ACRS?

Mr. **Brown**. I think Congress made a judgment to not reduce basis for the investment credit, which it gives to everybody.

Chairman **Stark**. We could belabor this. I appreciate your coming here to testify, and in the short time constraint, and I do appreciate your taking the trouble to point out some of the problems that we face in this area. I hope that we can correct them.

I would subscribe, if I could be convinced that it ain't broke I won't try to fix it, but I am sure you have heard other testimony here today to the contrary, I think from equally learned and experienced people.

I think where there is some honest disagreement, it behooves the committee to continue looking for ways to make the tax code a little more neutral, and perhaps even simpler. I appreciate you gentlemen taking the trouble to testify today.

The committee stands adjourned subject to the call of the Chair.

[Whereupon, at 2:55 p.m., the hearing was adjourned.]

[The following were submitted for the record:]

STATEMENT OF HON. PARREN J. MITCHELL, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MARYLAND

Mr. Chairman, Members of the Subcomittee, thank you for the opportunity to discuss the inter-relationship between corporate merger, acquisition and reorganization activities and Sections 302, 311(d), 331, 334(b)(2), 336, 337 and 346 of the Internal Revenue Code of 1954. In some instances corporate mergers may be beneficial for our economy, however, I believe that the Internal Revenue Code should be amended to remove those elements that encourage mergers solely for tax considerations.

Recently, the House Small Business Subcommittee on Antitrust, after extensive hearings, issued a report on the subject of conglomerate mergers and their effect on small business and local communities. The Subcommittee found that these conglomerate mergers have adverse effects on small business and local communities. Recent studies indicate that merger activity is frequently followed by increased economic concentration in various sectors of our economy which which may result in less competition, the closing of plants and business sites and the shifting of operations to other areas which may result in higher unemployment in the affected local community. There may be a direct correlation between tax benefits and the rash of merger and takeover activity. Thus, mergers between large companies may adversely effect the degree of competitiveness in our economy.

Under these circumstances, the basic rules governing tax treatment of corporate mergers, acquisitions and reorganizations need to be changed. Current law provides unintended benefits for corporate acquisitions structured as partial liquidations or stock redemptions.

It is for these reasons that Congressmen Harkin, Murphy, Bedell and myself introduced H.R. 5719, Excise Tax on Mergers. H.R. 5719 would impose an excise tax of 15 percent on certain takeovers by individuals, corporations, partnerships or trusts. The tax would be imposed on the value of the consideration furnished for the acquisition by the acquiring party.

In general, the tax would be paid by the acquiring party. The tax is in effect a toll charge on the ability of the acquiring party to obtain the tax benefits stemming from corporate takeover. The tax would apply only if either the acquiring party or the acquired party had receipts exceeding $2 billion for the year prior to the acquisition. Also, the other party must have had gross receipts of over $300 million for the year prior to the acquisition.

Under H.R. 5719 the provisions for stock acquisitions provide that the acquiring party must acquire (1) 50 percent of the voting stock of the acquired corporation or (2) 35 percent of the voting stock if that portion of the stock is worth at least $150 million. For asset acquisitions, the acquiring party must acquire assets having a value at the time of the acquisition of $150 million.

The tax does not apply to the acquisition of a loss company since there are other limitations in the Internal Revenue Code on such acquisitions. A loss company is a company with (1) a net operating loss in the year preceding the takeover year of at least 3 percent of the value of the company's assets at the close of the prior year or (2) an aggregate net operating loss for the four years preceding the takeover year of at least 10 percent of the value of the company's assets at the close of the year prior to the takeover year. In addition, the tax does not apply if the Secretary of the Treasury determines after consultation with the Secretary of Commerce that the acquired party faces substantial foreign competition and the acquisition would significantly improve the ability to compete with foreign companies. Thus, the provisions of H.R. 5719 would prevent tax motivated conglomerate mergers without adding a new level of complexity to the tax code that would impact adversely on small business.

I am also in favor of the approach taken in H.R. 6295, TAx Treatment of Corporate Mergers and Acquisitions, which will inhibit mergers that take place solely for tax benefits but also prevents revenue losses when the Congress is presently faced with the issue of budget deficits. H.R. 6295 is a step in the right direction in reforming our system of taxation so that it will become more neutral towards mergers.

I believe that the Subcommittee has correctly focused on two types of corporate merger, acquisition and reorganization activity. First, the sale of a corporate subsidiary to a buyer of the parent corporation's shareholders followed by a distribution of the subsidiary's stock in the redemption of the newly acquired shares. Secondly, the purchase of stock of a corporation followed by a partial liquidation. By the use of these techniques, the above-described transactions may result in an increased basis without a corresponding recognition of gain or recapture of depreciation allowances and investment tax credits by the selling corporation.

It is my feeling that these transactions should only be allowed if they are treated as what they truly are, I.E. sales of corporate assets and the taxes paid accordingly. In a time of large budget dificits we should not allow these tax avoidance techniques to continue.

Although H.R. 6295 has considerable merit, I am concerned about the complexity of some of its provisions because they may become a trap for the unwary small businessman. I would hope that the most complex provision could be given very careful analysis so that we do not further complicate our tax system with a new level of complexity.

Mr. Chairman, this concludes my prepared statement. Again, I appreciate the opportunity to present my testimony and I commend you and the Subcommittee for addressing this issue of mergers, acquisitions and reorganizations. If I can be of further assistance, please let me know.

Thank you.

AMERICAN FEDERATION OF LABOR AND
CONGRESS OF INDUSTRIAL ORGANIZATIONS,
DEPARTMENT OF LEGISLATION,
Washington, D.C., June 4, 1982.

Hon. FORTNEY H. STARK,
Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: This is in regard to the hearings held by your Subcommittee on May 24th on legislation relating to tax-motivated corporate mergers and acquisitions. The AFL-CIO generally supports legislative efforts intended to promote fairness and equity in the nation's corporate tax system, encourage competition by deterring mergers and corporate take-overs tending to result in economic concentration, and prevent the use of available credit to finance certain corporate mergers and acquisitions.

American workers and their unions have long been concerned about concentration of economic and political power into fewer and fewer hands. It is not simply a matter of the size and anti-competitive nature of giant corporations. There are serious political and social issues involving the power of big business over the lives of American citizens and over democratic government itself, quite apart from the negative impact of corporate concentration and power on inflation, efficiency, innovation, job-creation, and the American enterprise system.

The U.S. tax system should not be promoting or encouraging in any way economic concentration by mergers and corporate take-overs which bring to the parties involved windfall gains through federal or avoidance of taxes or through acquisition of tax credits.

The AFL-CIO on many occasions has stressed the need to channel available credit to productive purposes and to prevent greater concentration of corporate power as the result of excessive tax benefits for larger and wealthier business firms. In this regard, we urge favorable action by your Subcommittee on legislation along the lines of your bills, H.R. 6295, to reduce tax incentives for corporate take-overs, and H.R. 5855, to deny deduction for interest on loans in connection with take-overs or attempted take-overs. The 1981 AFL-CIO Convention resolution on "Tax Justice" in pertinent part, called upon the Administration and the Congress to: "Reinstate the corporate income tax as a source of revenue and equity and eliminate the so-called 'incentives' that subsidize mergers, takeovers, plant shut-downs, overseas investments and other activities that conflict with the national interest."

The AFL-CIO requests that this letter be included in the record of the hearings by your Subcommittee.

Sincerely,

RAY DENISON, *Director.*

SUBMITTED BY ARTHUR BURCK, PALM BEACH, FLA.

[From Inc., April 1982]

GIVE SMALL BUSINESSES THE TAX BREAKS ON MERGERS

(By Arthur Burck)

Since 1953, when I entered the merger business, I estimate there have been at least 50,000 corporate acquisitions and mergers in this country. Most were cases of huge companies taking over small ones. The majority of the companies acquired by the giants were weakened, damaged, or destroyed.

What often happens in these acquisitions was described by William Norris, a founder and chairman of Control Data Corp., when he and I testified before the U.S. Senate antitrust subcommittee in 1978:

"Immediately after a takeover, an innovation-stifling process sets in. The aggressor blankets the other with bureaucracy, layer upon layer * * * Proposals for new products languish * * * This process is compounded by employee trauma, because the more creative employees resign first. The result is the dispersal of the entrepreneurial team, the major job-creating resource of the company."

For several decades the giants have been picking off the best emerging companies by acquiring them. In the process, we have lost a generation of our most promising companies—and cut off many of the growth companies of the next generation as well.

In a changing world, there are many reasons why businesses should be sold or merged. But when acquisitions occur, the nation would clearly be better served if the buyer were another small or medium-sized company. In the corporate mating game, however, larger companies have the advantage. Bigness begets bigness, while taxpayers and small businesses pay the bill.

Who stacked the deck for the big companies? Unwittingly, Congress did. The giants' voracious appetites for growing companies—and in recent years for other giant firms—are whetted by three tax breaks: (1) the tax-free exchange of stock; (2) the deductibility of interest on the huge loans that float these deals; and (3) the use of retained earnings to help finance the acquisitions.

Let's look at the first situation. The average seller of a business wants a generous tax-free exchange of stock. He "rolls over" the investment in his present company for the marketable stock of another fompany. The bigger the partner, the better: A blue-chip stock gives the seller ready liquidity. He can turn the stock into cash—without paying a capital gains tax—by borrowing from a bank, using the stock as collateral.

Small or medium-sized acquirers are usually privately held or their stock is not actively traded. Therefore, in practice, they can't benefit from a tax-free exchange. As a consequence, small company owners who want ready cash find their assets "locked in," unless they are willing to merge with a larger company.

Now consider the giants' second advantage. Unlike small and medium-sized companies, they have no difficulty borrowing to finance acquisitions—on preferred terms. In the past four years most of the hostile takeovers have been for cash, at least in part. It's ironic that small business is starved for capital at the very time the giants are spending billions on takeovers—often just to use up surplus credit. What makes these deals doubly attractive to the buyers is that, since the interest is deductible, about half of an acquisition's carrying charges are borne by the U.S. Treasury.

Legislators have been diligent in curtailing interest deductions for small business. For example, the Tax Reform Act of 1969 restricts interest-deductibility of debentures as a means of buying another company. Only "poor" companies that can't readily obtain the necessary cash need resort to paying with debentures; the deductibility restriction doesn't apply to borrowed cash. And although huge corporations may deduct interest payments without limit, woe betide an individual who borrows to make investments and tries to deduct more than $10,000 annually.

As for the third advantage, the incentive to retain earnings to finance acquisitions is created because shareholders' dividends are taxed at ordinary income rates. If a corporation reinvests its earnings, the increased value of its stock is taxed only at the lower capital gains rate—and then only when the shareholder sells. So corporations are encouraged to keep and reinvest profits rather than pay big dividends. Consequently investment money usually stays locked up in big corporations—many of which can think of nothing better to do with the cash than buy other corporations.

How can we end this discrimination against small companies? First of all, we should not entirely do away with the tax-free exchange. In 30 years I have seen thousands of transactions in which legitimate and proper ends were served be tax-free mergers. This option was written into the law in recognition that businesses, in a dynamic capitalist economy, must have the flexibility to meet changing conditions.

This privilege was structured primarily to benefit the small and growing business, but it has functioned contrary to the lawmakers' intent. We need to restore the original purpose of this legislation by limiting the privilege to companies below a certain size—say, $200 million in assets.

Second, when a borrower is above this size, we should remove the tax exemption on funds borrowed for the acquisitions.

Here's a solution to the third inequity. Giving managment an incentive to retain earnings within the company would be fine if management invested the funds in new, productive assets instead of buying up other firms. Why not limit the tax breaks for big companies to corporate earnings actually reinvested in equipment, research, or production? Otherwise, earnings would immediately be taxed as income to shareholders—without the capital gains break.

We should similarly encourage investors to take their holdings in large corporations and reinvest them in small business. Huge pools of capital lie dormant in stocks and properties that were acquired long ago at a fraction of today's prices. Holders often "sit tight" with them to avoid paying capital gains taxes. Investors should be permitted instead to sell and invest the proceeds in small business, deferring the capital gains tax until the small business investment is sold.

The mammoths have benefited from government largesse totaling countless billions of dollars during recent decades. If we remove the tax incentives that for so long have fueled their mergers, the activity will shift to small and medium-sized companies. That is the sector where mergers are needed to keep our capitalism dynamic. The industrial future of America lies with the nimbler businesses. Mergers among these smaller organizations are often the best way to hasten the growth of new creative entities.

[From the U.S. News & World Report, December 21, 1981]

INTERVIEW WITH ARTHUR BURCK, BUSINESS CONSULTANT—MERGER BOOM CAN LEAD TO "DINOSAUR" COMPANIES

Question. Mr. Burck, do you expect the merger boom to continue?

Answer. Yes. And if recent trends continue—and I predict they will—it is likely that by the year 2000, several score multinational corporations will control most of the nation's industrial assets. By then, our industry could be a stagnant mess, dominated by many dinosaurs. By that time, too, we also could have a long history of quasi nationalization through Lockheed-Chrysler-style bailouts.

Question. What is fueling this worldwide trend?

Answer. People you sit in the executive chambers of huge companies are beginning to see a bleakness in the future of their own businesses and the difficulties of expanding their markets, especially with tougher competition from abroad. They compare the cost of building new plants to the cost of buying established firms. Stocks are selling at such depressed prices that many firms choose to jump on these targets of opportunity.

Question. Does bigness hurt compaines?

Answer. Bigness in itself isn't bad. Most big firms are in industries where bigness is appropriate. But acquisitions can cause problems when companies get too big or start moving into somebody else's field.

Question. What types of problems?

Aswer. First, the merger process has destroyed or weakened thousands of businesses that were star performers when they were independent. During the warfare of a hostile takeover, the target firm's management may be so seriously wounded that the company loses the quality that made it successful.

In many cases, the parent company doesn't have enough geniuses to manage somebody else's company as well as its own operations. Some acquiring firms try to avoid these pitfalls by keeping the target's corporate structure intact. That can be even worse, because now there are two bureaucracies.

But perhaps the greatest danger is that when companies get too big, they often lose the capacity to take risks and develop new products.

Question. Why are big firms poor innovators?

Answer. As companies increase in size, there is a commensurate increase in bureaucracy, which becomes more and more inflexible. In the business world, change is the name of the game. Yet it is the very nature of bureaucracy to resist change.

Another factor that leads to corporate stagnation is that the larger the company, the greater its stock in the status quo. When investments in established products and methods run into billions of dollars, manufacturers are reluctant to retool. The auto industry was slow to jettison the colossal investments in large cars until foreign competitors took the lead.

Question. What impact does the trend toward bigness have on the economy?

Answer The creation of gargantuan corporations with awesome economic and political power poses a threat to our democratic institutions. When the nation's economy is concentrated among a handful of huge corporations, the next major step will be the takeover of giants by the government.

Question. Do you favor legislation that would curb merger activity?

Answer. Yes. Eliminating tax-free exchanges of stock that many firms employ to buy other companies would be the simplest way. Another tactic would be to bar huge companies from deducting the interest on loans used to finance takeovers. But if you tried to get these tax breaks enacted today, you'd be laughed out of Congress.

Question. Should we halt all mergers?

Answer. No. Some mergers are necessary. Every firm must change ownership sooner or later. There are many reasons why a business should be sold. To name a few: Death of the owner or founder, technological obsolescence of the firm's product, changing markets, need for greater economies of scale and the inability to obtain sufficient investment capital. Generally speaking, it is only the smaller companies that really need to be sold or merged. The real test of a merger's necessity should be need, not greed.

STATEMENT OF HERBERT L. CAMP, BEFORE THE SENATE COMMITTEE ON FINANCE, ON BEHALF OF THE NEW YORK STATE BAR ASSOCIATION TAX SECTION CONCERNING S. 2687, CORPORATE TAKEOVER TAX ACT OF 1982

My name is Herbert L. Camp. I am Co-Chairman of the Committee on Corporations of the Tax Section of the New York State Bar Association. The Tax Section has over 2,800 members, all of whom are lawyers with a professional interest in taxation. They include practicing lawyers, judges, professors of law, corporate counsel, and officials and employees of the Treasury Department and the Internal Revenue Service.

I am pleased to testify with respect to S. 2687 (the "Bill"), introduced by Senator Danforth, concerning certain tax aspects of corporate takeovers. The Bill is substantially identical to H.R. 6725, introduced by Mr. Stark on June 28, 1982, and is similar to H.R. 6295, previously introduced by Mr. Stark.

I would like to comment particularly on Title II of the Bill, dealing with proposed new section 338 of the Internal Revenue Code (the "Code"), and Sections 101 and 102 of the Bill, dealing with, respectively, partial liquidations and redemptions using appreciated property.

I. GENERAL

The Tax Section is in favor of parts of the Bill which seek to abolish certain provisions of the tax law which, perhaps contrary to Congress' intention, may unduly facilitate certain corporate acquisitions. The Tax Section is opposed, however, to enactment without further study of those parts of the Bill which go beyond the correction of those perceived abuses. The Bill in its present form contains many complicated provisions. There is a significant risk that the Bill, if enacted without change, will produce an unworkable set of rules which the Congress will find necessary to delay pending further study, as has happened repeatedly in the case of section 382 of the Code (involving loss carryovers).

Congress should, we believe, note the example of the Installment Sales Revision Act of 1980, which, most agree, was a significant improvement in the tax law. That Act took over one year to approve, and was a single-purpose bill. The present Bill is in distinct contrast to that situation in that it is to be taken up as part of a broad revenue raising proposal, under intense time pressure, and without the deliberate study and reflection of the professional community. The result will, we fear, not be improvement of the tax law, but only its complication.

II. SECTION 338

A. *Description of section 338*

Title II of the Bill would, essentially, repeal section 334(b)(2) of the Code and substitute for it new section 338. Under the new section, a corporation acquiring 80 percent of more of the stock of another corporation (the "Target Corporation") within a certain time period could elect to treat the Target Corporation as if it had sold all its assets in a section 337 transaction at a price based on the purchase price for the stock.

Significantly, the section 338 election as to a Target Corporation would also apply to all its direct and indirect subsidiaries ("Target Affiliates"), including foreign subsidiaries. Sections 338 (e) and (g)(3)(B). Moreover, the section 338 election would be deemed made as to a Target Corporation (and therefore as to all Target Affiliates) if any asset of the Target Corporation or a Target Affiliate were acquired by the purchasing corporation during a period (called the "Consistency Period") beginning one year before the acquisition period and ending one year after it. Section 338(d)(1).[1]

As a result of that rule, a corportion acquiring assets in a section 337 transaction would be deemed to have elected under section 338 with respect to any acquired subsidiaries (because such subsidiaries would be Target Corporations and assets would have been acquired, within the Consistency Period, from an affiliate (the parent which sold in the section 337 transaction)). Likewise, if a corporation were liquidated under sections 331 and 336 of the Code, and its assets, or some of them, including subsidiaries, were sold by the shareholders to an acquiring corporation, section 338(e) would require that if section 338 were elected as to one acquired subsidiary, it would have to be made as to all acquired subsidiaries.

The election under section 338 is to be made within 75 days after the acquisition of the requisite 80-percent stock interest.

B. *Comments*

1. *General.* The Tax Section is in favor of the repeal of section 334(b)(2) and the substitution of an election not requiring an actual corporate liquidation in order to treat the transaction as an asset acquisition. The effect under the Bill would be to shorten considerably, compared to present law under section 334(b)(2), the maximum period between the effective date of the stock acquisition and the deemed asset purchase. The Tax Section believes that the resulting elimination of complicated interim earnings and profits calculations and other adjustments to tax basis is a desirable simplification of the tax law.

2. *Election Period.* We believe that 75 days is far too short a time period in which to determine the desirability of, and make, the section 338 election. Whether the election is desirable will depend in the usual case on a complex interplay of factors, including valuations, discounting of tax benefits, and determination of recaptures. Moreover, there would appear to be no detriment to the parties or the government if the election period were extended. We would suggest that the acquiring corporation be permitted to make its section 338 election as late as the actual filing date of the first tax return (its own or the seller's) for a period after the acquisition, since that is the first time it will make a difference whether the election is made. Alternatively, the election period could end 9 months (plus 15 days) after the acquisition, since, in many cases, neither return would be filed before then (taking into account extensions of time).

3. *Basis.* The Bill provides that the basis of assets under a section 338 election is the purchasing (electing) corporation's basis for the acquired stock, properly adjusted for liabilities and other relevant items. Where 100 percent of the Target Corporation's stock is acquired, the basis calculation should be relatively straightforward, and that is a distinct improvement over present law. It is not entirely clear, however, what the basis is in the case of a less-than-100-percent purchase of stock. Presumably, the Target Corporation's existing asset basis continues to the extent of the percentage of stock not acquired. For instance, if only 80 percent of the Target Corporation is purchased, for $8 million, liabilities of the Target Corporation are $4 million, and the assets have an old tax basis of $6 million, then the assets should have a new basis of $12.4 million ($8 million, plus 80 percent of $4 million, plus 20 percent of $6 million.)[2] Perhaps the basis rules in such a case could be spelled out in the statute or the legislative history.

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[1] An exception is provided, so that there would be no deemed election, in the case where the acquiring corporation's basis in the asset was determined by reference to the transferor's basis or the transfer was an ordinary course-of-business sale. Section 338(d)(2).

[2] Another way to look at it is to observe that, in a 100-percent purchase (for $10 million), basis would be $14 million, or an $8 million step-up. 80 percent of $8 million is $6.4 million, which, when added to the existing $6 million of basis, equals $12.4 million.

Also, a case could be made to treat certain preferred stock, not acquired by the acquiring corporation, like a liability for purposes of basis calculations. For instance, if 100 percent of the common stock of a Target Corporation were acquired for $8 million, there were no liabilities, the assets had an old basis of $2 million and there were $2 million in liquidating value of preferred stock, which was not acquired, then treating the preferred stock as stock would produce a new asset basis of $8.4 million, but treating the preferred stock as a liability would result in a new asset basis of $10 million.

4. *Subsidiaries.* We have great difficulty with the complex rules in proposed section 338 which mandate that the election apply to all subsidiaries (including, as mentioned above in section 337 and certain section 331 situations).

We understand that those complicated provisions are included in order to avoid giving a purchaser a "selective" step-up in basis. We do not believe that the buyer's choice as to which corporations should be subject to a step-up in basis, with attendant recaptures, is an abuse. The corporate tax law has for many years permitted a purchaser that choice, and a change at this point would dramatically affect the value of existing corporations that own subsidiaries. The practical effect of the solution in the Bill requiring complete step-up and recapture for all subsidiaries is to go well beyond the elimination of tax provisions which unduly favor corporate takeovers, and may be to stop altogether many acquisitions which otherwise would occur and the consummation of which would be healthy for U.S. commerce.

In the first place, the provisions as to subsidiaries seem to be premised on an exaggerated view of a corporation's ability under present law to tailor its assets in connection with a takeover transaction. The proposed treatment of subsidiaries is not necessary to deal with the situation where a target corporation, in anticipation of its sale, rearranges it affairs, for instance, by placing in a subsidiary assets which would not be desired, because of heavy recaptures, to be stepped up. Such a rearrangement could well be subject to a section 269 or other [3] attack. Even if not, however, it could be considered part of an overall plan so that section 338 would apply to the assets of the Target Corporation and those so placed in a subsidiary. That would make it unnecessary to have an automatic rule requiring that all subsidiaries be the subject of the election.

Second, if the Target Corporation has historically conducted business in subsidiaries, there seems to be no good reason to treat the purchase of stock of subsidiaries as an asset purchase merely because the parent corporation's assets are purchased, or treated as purchased. Such treatment in effect ignores the separateness of the various corporate entities which would theretofore have been respected. On the other hand, the separateness continues to be respected for other purposes. For instance, the liquidation of a parent corporation does not fail to be a complete liquidation merely because its subsidiaries are not also liquidated.

Third, the proposed treatment of subsidiaries is particularly onerous in the case of foreign subsidiaries that are controlled foreign corporations. A step-up in asset basis with respect to such subsidiaries is not likely to result in any decrease in U.S. taxation; but under section 338 the assets of each foreign subsidiary will be deemed to have been disposed of, and apparently each subsidiary will be deemed liquidated, in every section 338 situation. In that event the United States shareholder would be taxable on income equal to the "all earnings and profits amount" of the foreign subsidiaries or, at the election of the shareholder, all the gain on the liquidation would be taxable, and section 1248 would apply to the extent of post-1962 earnings and profits. See, Temp. Reg. § 7.367(b)-5.[4]

Moreover, the deemed asset sales by the subsidiaries will produce recapture of depreciation with respect to personal property which will increase their earnings and profits which in turn are taxed under either section 367 or section 1248. Because of the increase in earnings and profits, a "dilution" of any foreign tax credit associated with the subsidiary's earnings and profits will also result.[5] There is no reason to accelerate the taxation of the earnings and profits of foreign subsidiaries in a takeover situation; foreign profits will still be subject to U.S. taxation when actually realized, by sale or distribution, in later years. Such mandatory acceleration of tax may well frustrate, or at least greatly complicate, normal acquisitions which are beneficial to the U.S. economy.

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[3] *See, Telephone Answering Service Co.* v. *Commissioner,* 63 TC 414 (1974), *aff'd.,* 546 F.2d 423 (4th Cir. 1976), *cert. denied,* 431 U.S. 914 (1977) (no complete liquidation where some assets remain in corporate solution after the transaction).

[4] Another possibility would be to view the transaction as a sale of stock of the first tier foreign subsidiary subject to section 1248. Under section 1248, gain recognized on the sale of stock of a controlled foreign corporation by a United States shareholder is generally taxed as a dividend to the extent of the controlled foreign corporation's post-1962 earnings and profits. Section 1248 tax applies already in the case of first-tier foreign subsidiaries of a target corporation whose assets are sold or which is liquidated, even if gain is generally not recognized under sections 337 or 336. Section 1248(f) of the Code. Under the Bill, the election (or deemed election) under section 338 with respect to a domestic subsidiary could in effect result in section 1248(f) treatment of lower-tier foreign subsidiaries.

The extension of section 338 to subsidiaries will also cause taxation of accumulated DISC income of lower-tier DISC subsidiaries. As in the case of foreign subsidiaries, the sale of the stock or assets of the remote parent of the DISC seems to be an inappropriate reason to end the DISC deferral; the result will be to eliminate the favorable export incentive of the DISC structure.

Another consequence of the extension to subsidiaries could arise in the case of life insurance subsidiaries, which would be deemed to have sold their assets and could, as a result, incur substantial—and we believe unintended—tax liability, well beyond mere recaptures, as a result of the transaction.

Finally, the extension of section 338 to subsidiaries makes the section far more complicated and burdensome than it would be without such extension.

We strongly recommend that the provisions of the Bill which require that the section 338 election be applicable to subsidiaries be deleted. A separate section 338 election should be available for each subsidiary that was acquired by "purchase," provided that each higher-tier subsidiary in the chain of which the subsidiary was a part so elected. At most, section 338 could include a provision to the effect that the election would extend to assets transferred from the Target Corporation to its affiliates within two years of the acquisition, unless the taxpayer established that the transfer was not effected for the principal purpose of avoiding a section 338 election as to them. If, following enactment of the Bill in that form, it became apparent that a strengthening of section 338 were required, that could occur; but it is not desirable at present to take so radical a step as the Bill now contemplates.

III. REDEMPTIONS USING APPRECIATED PROPERTY

A. Description of bill

Section 102 of the Bill would repeal sections 311(d)(2)(A), (B), (C) and (G) of the Code. Those sections provide four exceptions to the general rule of section 311(d), that a corporation recognizes gain on the distribution of property in redemption of stock. The exceptions are: (1) a distribution of assets to a 10% or more shareholder, in complete redemption of his stock held at least one year (section 311(d)(2)(A)); (2) a distribution of stock or debt of a 50% or more owned subsidiary (section 311(d)(2)(B)); (3) distributions in certain Sherman or Clayton Act proceedings (section 311(d)(2)(C)); and (4) certain distributions under the Bank Holding Company Act (section 311(d)(2)(G)).

B. Comments

1. *General.* The Tax Section believes that a reduction in the scope of section 311(d)(2)(B) is called for. We do not believe, however, that it is necessary or desirable to repeal that section, and we see no reason for significant change in or repeal of sections 311(d)(2)(A) and (C) at the present time.

The issue of broadscale repeal of the section 311(d)(2) exceptions, as opposed to amendments merely to deal with perceived abuses, raises the fundamental question whether a corporation should recognize gain (or loss) on the distribution of its property to its shareholders.

Present law follows the rule of *General Utilities & Operating Co.* v. *Helvering,* 296 U.S. 200 (1935), which is codified in sections 311 and 336 of the Code. Under that rule, a corporation generally does not recognize gain or loss on property distributions to shareholders, whether as dividends, in redemption of shares, or in liquidation.

In 1969, Congress amended section 311 to provide for recognition of gain (but not loss) in certain corporate redemptions. At that time, the exceptions to gain recognition now at issue were enacted.[6] The impetus for the 1969 legislation was a perceived abuse—certain corporations, principally insurance companies, were using appreciated portfolio securities to retire stock.[7] The 1969 amendment did not constitute, nor would it appear that there was any intent that it should, a broad attack on the *General Utilities* concept, but was rather merely a narrowing of its scope.

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[5] On the other hand, no step-up is likely to be allowable for foreign tax purposes, with the results that future foreign taxes will be higher than using U.S. concepts of taxable income, and that excess foreign tax credits may result in later years. In the end, there could be substantial unwarranted double taxation, United States and foreign, on the foreign earnings.

[6] Section 311(d)(2)(G) was enacted in 1976.

[7] See, S. Rept. No. 91-552, 91st Cong., 1st Sess., at 279.

It is apparent that one impetus for the Bill's proposal concerning section 311 is a particular perceived abuse. (See the discussion of section 311(d)(2)(B), below.) It may also be appropriate, at some point, to re-examine the fundamental concept involved, the *General Utilities* rule. We suggest, however, that the present Bill be confined to urgent changes to deal with abuses, and that the re-examination be done apart from the Bill, without the pressures attendant to a hastily conceived bill to raise critical revenues.

In that re-examination, Congress should focus on the extent to which a double-tax system is appropriate where corporate property is distributed to shareholders. The present rule—*General Utilities*—results in a partial integration system. The Bill's broadside repeal of the section 311(d)(2) exceptions would move significantly away from that integration. That is a fundamental change which may or may not be desirable, but we see no good reason to put it into effect now, without thorough study and debate.

2. *Section 311(d)(2)(B).* The Tax Section believes that section 311(d)(2)(B) should not be repealed now, but should be narrowed so as to eliminate its availability in corporate acquisitions.

In a number of recent, well-publicized transactions, corporations have been able to dispose of subsidiaries to buyers which acquired the stock of the corporation with a view to a redemption exchange. Whether the disposition is a redemption exchange, and thus tax-free under section 311(d)(2)(B), has produced much debate.[8] Essentially, the issue, which is common to most transactions involving three parties (here, the corporation, the buyer, and the selling stockholders of the corporation), is whether (1) the subsidiary was transferred to the buyer for stock which it acquired from the selling stockholders, or (2) the subsidiary was sold to the buyer for cash which the corporation used to buy in its stock from the selling stockholders. Either construction is consistent with the end result, but under one construction the transaction is taxable to the corporation and under the other it is not.

We believe that the benefits of section 311(d)(2)(B) should be available only to historic shareholders of a corporation, not to persons which buy shares with a view to exchanging them for corporate assets. Accordingly, we believe that section 311(d)(2)(B) should be amended to provide that it does not apply to a redemption of stock held for less than two years.[9] We suggest two years because we believe that there is no doubt that a potential purchaser would not hold corporate stock (usually a minority position) for two years to obtain corporate assets, and that the corporation would likewise not want its shares to be held by that purchaser for so long a period.[10] As a result, a two-year holding period under section 311(d)(2)(B) would effectively preclude its use in a corporate takeover. More sweeping change than that is not warranted at present.

The suggested amendment of section 311(d)(2)(B) should also be accompanied by a provision to permit the distribution of a corporate subsidiary, otherwise qualifying under that section, to a diverse group of shareholders, where there is obviously no takeover context. An example is a distribution to all or most stockholders of a publicly-held corporation (even a pro-rata redemption); in that example it would be difficult to establish the various holding periods of public shareholders so as to demonstrate compliance with the amended provision.

3. *Section 311(d)(2)(A).* We are not aware that section 311(d)(2)(A) has been effectively used as a takeover device.[11] On that basis, we would suggest that there is no need to repeal or alter the section. However, if our suggestion of a two-year holding period under section 311(d)(2)(B) is adopted, it would seem logical to have the same holding period established for section 311(d)(2)(A).

4. *Section 311(d)(2) (C) and (G).* The distributions involved in section 311(d)(2)(C) are not used in corporate takeovers. Moreover, they are essentially involuntary transactions arising under the antitrust laws. We see no reason to eliminate that

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[8] Compare *Standard Linen Service, Inc.*, 33 T.C. 1 (1959) (*acq.*), with *Idol v. Commissioner*, 319 F.2d 647 (8th Cir. 1963), *aff'g* 38 T.C. 444 (1962). See also L.R. 8042140.

[9] Indeed, even one year might well be enough. As mentioned below (page 17), the one year holding period of section 311(d)(2)(B) seems to have prevented its use in takeover contexts.

[10] A provision should be included to the effect that stock held by a person that had a contractual right to exchange the stock for a subsidiary of the issuer would not be considered as being held for purposes of the holding period requirement.

[11] That is because of the one-year holding period requirement in the section. See Rev. Rul. 80-221, 1980-2 C.B. 107, for an attempt to use section 311(d)(2)(A) in a takeover context. The attempt was not successful.

exception in the context of a bill to make the tax law neutral as to corporate takeovers.

As to section 311(d)(2)(G), involving distributions under the Bank Holding Company Act and section 1101 of the Code, such distributions would not occur after December 31, 1980 and the elimination of section 311(d)(2)(G) therefore appears appropriate.

5. *Partial Liquidations; Spin-offs.* We discuss partial liquidations more generally in IV, below. We note here, however, that the tightening of section 311(d)(2) would also call for tightening of partial liquidations and section 355 transactions.

Assuming for the moment that the partial liquidation provisions are not repealed (as is our recommendation), it would be necessary to prevent a buyer from acquiring corporate stock to be surrendered in a partial liquidation (tax-free to the corporation under section 336) for a desired corporate asset. Indeed, the *Standard Linen* case itself involved that kind of partial liquidation. We suggest that the same two-year holding period as is suggested under section 311(d)(2)(B) requirement be added in the partial liquidation context to confine the use of a partial liquidation to historic shareholders.

As to section 355, we believe that attention should be given to the question whether corporate assets can be acquired, in a takeover context, on a tax-free basis using the tax-free spin-off provisions. For instance, it is at least arguable that section 355 could be applicable to the distribution of a 100 percent owned subsidiary to a stockholder in redemption of its stock, even though such stock was recently acquired for cash in order to be used in the redemption. If section 355 does apply, then there would be no tax to the distributing corporation, even if the recommended amendments were made (or if the Bill's provisions were enacted in toto) with respect to sections 311 and 346. Accordingly, Congress should prevent section 355 from being used as a corporate takeover vehicle just as sections 311(d) and 346 could be used. The failure of the Bill to cover that point is an excellent example of why legislation in the complex area of Subchapter C should be undertaken only with deliberate care, and not as part of an intense, accelerated revenue-raising package.

IV. PARTIAL LIQUIDATIONS

A. *Description of bill.* The Bill would repeal the partial liquidation provisions of section 346 of the Code, and amend section 302 of the Code so as to permit sale or exchange (capital gain) treatment to a shareholder in certain transactions now qualifying as partial liquidations.

C. *Comments*

1. *General.* The partial liquidation provisions of the Code have been used in certain recent takeovers. We believe that there is one significant loophole in the present scheme (the elimination of investment credit recapture under the Consolidated Return Regulations) which should be closed, and that a case could be made that there is another possible loophole (deferral of depreciation and other recaptures under such Regulations) which might well be closed. Beyond that, we do not believe that it is clear that any change in law is warranted.

2. *Investment Credit Recapture.* Under present regulations, the distribution of assets in a partial liquidation to a corporate shareholder does not result in investment credit recaptures if the parties file a consolidated tax return. We believe that, in a takeover context, i.e., where the credits were earned before affiliation, that is clearly wrong and that the Consolidated Return Regulations should be amended prospectively or that a legislative override of the Regulations should be enacted.

3. *Depreciation Recapture.* Under present regulations, the distribution of assets in a partial liquidation in a consolidated return situation is a deferred intercompany transaction, so that income recaptures are recognized, but deferred and restored (i.e., added to income) as the basis step-up is used by the distributee. Where the item being recaptured (e.g., depreciation) was earned prior to consolidation, it is arguable that deferral is inappropriate. (Deferral is certainly appropriate to the extent the item was earned during, rather than before, consolidation.) On balance, we would recommend that the Consolidated Return Regulations be amended, prospectively, to eliminate deferral for recapture of pre-affiliation items, or that a similar legislative override be provided.

4. *Other Changes.* It is arguable that, in a consolidated (or even in any intercompany) situation, basis step-up to a distributee corporation should not occur selectively (i.e., in a partial liquidation) at all. The argument would be that section 334(b)(2), which presumes a complete liquidation, should be the exclusive route to a step-up in basis, and that in a mere partial liquidation, the corporate parties, both distributing corporation and distributee corporation, should be treated the same as if the assets

were not distributed in liquidation, but instead under section 301 of the Code. (That would result in basis carryover, not step-up.)

Such a rule could be adopted by regulation if it were confined to corporations filing consolidated returns, but the logic of the rule would seem applicable to all intercompany situations, whether consolidated returns are filed or not. That suggests a legislative solution.

We take no position whether the foregoing rule should be adopted. The consolidated return recapture rule changes recommended in paragraphs (2) and (3), above, may be adequate to deal with corporate takeover problems in the partial liquidation context. We do feel strongly, however, that there is no good reason to repeal the partial liquidation provisions as applicable to distributions not in an intercompany context.[12] We recommend that section 346 be retained in its present form for distributions other than to 80% corporate shareholders. Thus, section 336 would still prevent recognition of gain to the distributing corporation in such a partial liquidation. The section 302 amendment would be unnecessary in that event.

We note that under proposed new section 302(a) (section 101(c) of the Bill), it might be necessary to have an actual stock redemption in order for the section to apply. That is the rule under section 302, although the rule under section 346 is different.[13] If proposed section 302(e) is enacted, it should be made clear that the rule of *Fowler Hosiery* will apply.

V. EFFECTIVE DATES

A. *Description of Bill.* The provisions of the Bill relating to sections 338 and 334(b)(2) apply to acquisitions occurring after August 31, 1982. The amendments to sections 331 and 346 apply to distributions after that date.

B. *Comment.* The Tax Section believes that the foregoing August 31 effective date should be changed to the later of the date of enactment or December 31, 1982. As a general matter, we think that the effective dates in the Bill should not be so soon as to disrupt pending transactions which were planned and as to which there has been reliance, including the incurrence of transaction, costs, on existing law, at least where the result under current law was acknowledged by the government. For instance, the consolidated return treatment of recaptures in a partial liquidation is clear under the regulations and the Internal Revenue Service (the "Service") has issued frequent favorable rulings on the subject.[14] Transactions may be pending which will not close by August 31, but which were planned based on those authorities and pursuant to which taxpayers have incurred substantial costs. It would be unfair for the effective date of Title I of the Bill to be so soon as to apply to such transactions.

As to the section 311 amendments (i.e., the essential amendment to (or repeal of) section 311(d)(2)(B)), the corporate takeover technique involved is obviously not clearly permitted by the Service and may well be challenged by it. On the other hand, the correct result is by no means clear and may vary from case to case depending on the facts. Under the circumstances, we believe, the effective date should permit existing law (as to which no inference should be drawn from any amendment to section 311) to apply to transactions which are closed before 1983.

As to section 338, a prompt effective date would not be objectionable if the section only applied (as we strongly recommend) to the Target Corporation and those subsidiaries elected by the purchaser. Extension of section 338 to all subsidiaries, however, would in fairness call for a more delayed effective date. Parties could be substantially committed to many transactions (although there might not technically be binding contracts) in contemplation of existing section 334(b)(2), and if section 338 is to apply to subsidiaries, such transactions should be permitted to close based on existing law. We therefore recommend that the effective date of section 338 be December 31, 1982, rather than August 31, 1982, provided, however, that a transaction which is substantially binding on the parties (apart from customary closing conditions, such as financial condition, updating of warranties, third party consents and approvals, etc.) on July 1, 1982 be permitted to close after 1982 under existing law.

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[12] Among other situations in which it is appropriate to retain section 346 is that of a family or other dispute among shareholders, and resulting division of a business (not qualifying under section 355).

[13] See *Fowler Hosiery* v. *Commissioner*, 301 F. 2d 394 (7th Cir. 1962); Rev. Rul. 79-257, 1979-2 C.B. 136; Rev. Rul. 81-3, 1981-1 C.B. 125.

[14] See, e.g., L.R. 8204064.

STATEMENT FOR THE CHAMBER OF COMMERCE OF THE UNITED STATES, BY RACHELLE B. BERNSTEIN, SENIOR TAX ATTORNEY, AND KENNETH D. SIMONSON, SENIOR TAX ECONOMIST, TAX POLICY CENTER

The Chamber of Commerce of the United States, representing over 240,000 businesses, trade associations, and local and state chambers of commerce welcomes the opportunity to submit testimony on H.R. 6295, the Corporate Takeover Tax Act.

SUMMARY

The stated objective of H.R. 6295, introduced by Mr. Stark, is to make the tax system more nearly neutral with respect to corporate takeovers so that it creates neither special benefits from nor impediments to mergers, acquisitions, or reorganizations. Unfortunately, the bill serves as more of a barrier to mergers and acquisitions than as a neutralizing force.

H.R. 6295 substantially revises Subchapter C of the Internal Revenue Code, the structure of which has been in the tax code since 1954. In so doing, the bill goes beyond its objective of curbing large corporate takeovers and seriously affects the restructuring of small business activities, especially those of closely held family corporations.

Furthermore, restrictions on the uses of net operating losses and credits discourage efficient allocation of capital. Such limitations will dissuade investment of risk capital in unproven ventures.

This legislation raises many important questions of tax policy. All of the ramifications of this bill cannot possibly be addressed in the short period of time allowed for comment. We urge this committee not to enact legislation in this area without examining all of the tax policy issues invovled and holding further hearings on the subject.

I. TAX POLICY WITH RESPECT TO MERGERS

The Corporate Takeover Tax Act discourages corporate mergers through modification of the Internal Revenue Code. Althought the stated purpose of the bill it to make the tax law neutral with respect to mergers and acquisitions, the proposals are not neutral. The proposed legislation serves as a barrier to the restructuring of a business by requiring a double taxation when a corporation redeems stock held by a major shareholder for assets: the shareholder is taxed on the appreciation of the stock which he redeems in exhange for assets of the corporation, and the corporation is taxed on the appreciation of the value on these assets.

Partial liquidations and stock redemptions are conducted more often by small and medium-sized firms than by large firms. These businesses do not enter into such transactions because of the tax consequences, but rather because they wish to buy, sell, or merge an operation for financial reasons. It is normally after such a decision is made that a businessman will request tax advice in structuring the transaction from his attorney or accountant.

Mergers, acquistions, and liquidations are essential to efficient allocation of resources in the economy. Without them, firms would be able to transfer resources only by selling assets individually (as opposed to ownership of the firm) or by going bankrupt, a process that disrupts jobs and capital. Mergers allow more orderly transfer of resources.

In addition, mergers can allow businesses to achieve greater economies of scale, by lowering production costs and, thereby make them more competitive. This process is important on both a local and national scale. Two local businesses may combine to successfully compete against a larger nationwide competitor and one or two domestic companies may combine to meet foreign competition, either in the domestic market or overseas. Without merging, one or both firms might otherwise go out of business.

There is no conclusive evidence that concentration is increasing or that the tax laws have led to economic concentration. Specific cases of mergers which produce anticompetitive results may be handled by allowing the market to operate to restore competition or through existing antitrust laws. Since the tax system is not encouraging overconcentration, any tax measure which discourages mergers is bound to have undesirable economic effects. Antitrust policy should not be written into the tax law, especially where the effects would be as far-reaching as they are in this case. The Internal Revenue Code is complicated enough!

II. EFFECTS OF H.R. 6295 ON SUBCHAPTER C

Subchapter C of the Internal Revenue Code, which sets forth the provisions for taxation of corporations, is one of the most complicated areas of tax law. These provisions, written into the Internal Revenue Code in 1954 based on corporate tax law dating back as far as the 1930's, are all predicated on certain basis tenets of corporate tax policy and greatly interrelate with each other. Therefore, Subchapter C should not be modified in a piecemeal fashion.

H.R. 6295 was introduced to remedy perceived abuses resulting from large corporate mergers. However, by modifying Subchapter C in the manner proposed, these few large corporate mergers would be discouraged at a price of adversely affecting a large number of transactions by small and medium-sized corporations which are not involved in "takeover" situations.

For example, where two brothers who have owned and operated a closely-held corporation decide to split their business because of a family dispute, they might traditionally have chosen to distribute a portion of the business to one of the brothers in redemption of all of his outstanding stock. Under present law, the redeemed brother would be taxed on the capital gain he realized upon receipt of assets. The family company would be liable for statutory recaptures. However, under the proposed amendment, not only would the redeemed brother pay full capital gains on the assets received, but the corporation would also pay a tax on the entire appreciation in value of the assets distributed. This double taxation of the appreciation of these assets is contrary to one of the basic tenets of our tax policy.

Another common transaction which would be affected by this bill is the situation where a parent sells the family business to his children. If the children cannot afford to purchase the entire business, the father could sell a portion of his stock to his children at an affordable price, and the corporation could distribute some assets to the father in redemption of the remainder of this stock. As to the stock which is redeemed, under present law the father would pay capital gains tax on the appeciation in value of his stock. There would be corporate level tax only to the extent of recapture on assets distributed. However, under the proposed legislation, the corporation would be taxed on the appreciation of the assets distributed and the father would be taxed on the appreciation of his redeemed stock, again resulting in a double taxation.

Both of these transactions illustrate the serious effect of the proposed legislation on the practical needs of a small closely held corporation. We do not believe the intention of H.R. 6295 is to deter the restructuring of a family business. Hundreds of similar non-tax motivated transactions are conducted by small and medium-sized businesses. H.R. 6295 was designed to impede a handful of large corporate takeovers, but these mergers will probably continue to take place. However, the legislation will hinder the normal restructuring of business all around the country.

The double taxation of corporate income when a corporation holds property that has appreciated in value and at the same time its shareholders hold shares of the corporation's stock that have similarly appreciated in value can be unduly burdensome. Should a double tax arise when a corporation distributes appreciated property to a shareholder in redemption of all of this stock, but not when a corporation completely liquidates and the shareholders operate their business in a partnership from?

The short period of time permitted for comment after the introduction of H.R. 6295 on May 6, 1082, was not sufficient for witnesses to respond to all of the possible ramifications of the proposed revisions to Subchapter C. Because of the great interrelationship of these rules, modification in Subchapter C should be made only after adequate study of all of the tax policy issues involved.

III. EFFECTS OF LIMITING CARRYOVERS

Job creation depends heavily on new businesses and on small businesses. But individuals will invest capital and entrepreneurship to start or expand enterprises only if they have a chance of securing adequate return for their risk-taking and of eventually passing on the business, either to heirs or to unrelated parties. Under present law, the decision as to the optimal timing of the disposition can be made with relatively little consideration for the current tax situation. H.R. 6295 would jeopardize this opportunity for many actual and potential entrepreneurs by arbitrarily reducing the value to a buyer of a business with loss or credit carryovers, based on the ownership share retained by the seller. Under the bill, an acquiring company would be willing to pay more for a share of Company A, whose owner retains 60 percent ownership, than for an identical company B, whose owner retains 20 (or even 59) percent ownership. But an entrepreneur may not be able to predict when he may optimally sell his equity interest in the business and may not know the degree of investment and ownership control he may wish to retain at that time. Thus the bill adds uncertainty and lowers the potential return to risk-taking. The result is bound to be less business formation and job creation.

The bill would also deter investment and undermine the incentive effects of the accelerated cost recovery system (ACRS). ACRS encourages investment by allowing faster writeoffs or higher investment tax credits (ITCs) than under prior law. As a result, more companies are likely to have net operating loss (NOL) or ITC carryovers, particularly in years in which they invest heavily. The basic purpose of the NOL carryover provisions is to serve as an averaging device, allowing a more even matching of income and expenses which is needed when a taxpayer is allowed to deduct expenses currently and the corresponding income several years later. Ironically, even though these investments may make a company more economically sound, it will be worth less to a purchaser under the bill if it has carryovers as a result of the investments. Thus, an owner contemplating sale of the firm would be less likely to undertake investment in fixed assets than under present law.

CONCLUSION

The complex area of tax law addressed by this bill should not be modified without allowing sufficient time for more careful study by Congress, Treasury, and the public. This need is evidenced by the fact that this legislation would have a far greater effect on small and medium-sized firms than on the large corporate takeovers to which it was addressed. We question the need for such anti-merger legislation, and we oppose enacting antitrust legislation in the tax code.

The Chicago Bar Association,
Federal Taxation Committee,
Chicago, Ill., June 22, 1982.

Re H.R. 4562, H.R. 5517, H.R. 5719, H.R. 5855 and H.R. 6295

Hon. Fortney (Pete) Stark,
Chairman, Select Revenue Measures Subcommittee, House Ways and Means Committee, Longworth House Office Building, Washington, D.C.

Dear Representative Stark: The Federal Taxation Committee of the Chicago Bar Association has reviewed the five bills captioned above on which your subcommittee recently held hearings. Enclosed with this letter are our comments on that legislation, most of which are directed toward H.R. 6295.

The extremely brief period permitted for comments precludes a detailed and technical analysis of the bills, even though such analysis is essential for legislation such as H.R. 6295 that would have a major impact on the entire structure of the corporate tax laws. Thus, our principal comment is a general one: dramatic changes in the current system of corporate taxation, such as those proposed in H.R. 6295, should be scheduled for hearings and comment over a period sufficient to permit careful analysis and consideration by the tax bar, business and the public.

We also note that H.R. 6295 will affect small, as well as large, corporations. The effect on small businesses should be carefully examined, since it could be extremely detrimental.

Due to the brief period allowed for consideration of this legislation, our comments cannot cover numerous issues and difficulties which may surface on closer examination. We, therefore, urge that any further consideration of H.R. 6295 in particular be accompanied by full public hearings and an extended comment period to permit the type of technical analysis such a major piece of legislation demands.

Very truly yours,

Neal J. Block, *Chairman.*

Enclosure.

Chicago Bar Association, Committee on Federal Taxation Comments on H.R. 4562, H.R. 5517, H.R. 5719, H.R. 5855 and H.R. 6295

H.R. 4562, H.R. 5517, H.R. 5719, H.R. 5855 and H.R. 6295 deal generally with the tax aspects of corporate mergers and acquisitions. Before discussing specific provisions of these bills, we make one overall observation, particularly with respect to H.R. 6295, to which the majority of our comments are directed.

H.R. 6295, if enacted, would bring about the most far reaching changes in the corporate provisions of the tax laws since the enactment of the Internal Revenue Code of 1954. The bill, as presently drafted, would either abolish or radically alter concepts which have been integral parts of the tax law for decades. It appears from the technical explanation of the bill prepared by the staff of the Joint Committee on Taxation that H.R. 6295 is primarily directed against a few well-publicized recent corporate acquisitions which could be considered to have made an abusive use of the provisions of Subchapter C of the Code to avoid the recognition of gain or recapture of income. We suggest that a central concern of the subcommittee before which these bills are pending should be whether a more narrowly drawn provision is not a more apropriate way of dealing with such transactions than a complete restructuring of Subchapter C and, moreover, whether administrative and judicial action is not adequate to police such transactions.

We do not mean to suggest that any provision of Subchapter C is sacred solely because it has existed for a long time, and indeed H.R. 6295 contains some provisions which we regard as useful reforms. However, we would caution that Subchapter C is one of the most highly technical portions of the Code and that any revision to it should be carefully considered and thoroughly discussed through the public hearing process to avoid unintended side effects which may follow from a hastily adopted amendment.

H.R. 6295 was introduced on May 6 and set for hearings on May 24, with written comments due by June 4. One month is simply not enough time for a responsible and adequate study of all of the implications of so sweeping a measure. Accordingly, although some technical aspects are discussed herein, we have not attempted a comprehensive technical critique of the bill. Rather, the purpose of these comments is to discuss general policy issues which are raised by all of the bills being considered. If the subcommittee decides to proceed with this legislation, we urge that the bill be set for full hearings, so that the proposed amendments may be carefully reviewed by tax practitioners, the business and financial community, and interested members of the general public.

I. H.R. 6295

A. Treatment of distributions.—Title I of H.R. 6295 makes two principal changes in the treatment of corporate distributions. First, the concept of partial liquidations is abolished. Although some distributions which previously qualified as partial liquidations under Code section 346 would be incorporated into a new class of redemptions under Code section 302, all distributions other than those in complete liquidation of a corporation would, at the corporate level, be treated under section 311. Second, section 311 would be amended so that most distributions by a corporation of property with a value in excess of its basis would result in the recognition by the corporation of the appreciation.

1. ABOLITION OF PARTIAL LIQUIDATIONS

The stated principal rationale for the abolition of partial liquidations is that such liquidations may permit a corporation, through the exercise of "undue selectivity", to distribute in partial liquidation only assets in which a stepped-up basis is desired and to retain assets with a high recapture potential. We do not feel that the problem of "undue selectivity" has been adequately demonstrated. The standard for determining when a distribution by a corporation constitutes a partial liquidation is, at least theoretically, well established: the distribution must represent a substantial contraction of the corporation's business. This standard is normally understood to mean that the corporation must cease to engage in some identifiable portion of its business, which would seem to preclude the asset-by-asset selectivity perceived as the problem. If the concept of a partial liquidation is a valid one, as we believe it to be for the reasons discussed below, we do not believe it should be totally abolished unless it can be clearly shown that it is inherently incapable of being rationally defined and limited by the courts and the Internal Revenue Service.

Prior to the adoption of the 1954 Code, there was no separate provision for partial liquidations in the tax laws. All distributions other than those in complete liquidation were treated as dividends to the extent of earnings and profits unless they could be shown to be not "essentially equivalent to a dividend." Under this standard, the courts developed the principle that a distribution which constituted a contraction of the corporation's business was in essence a liquidation of a portion of the business and should be taxed under the provisions relating to corporate liquidations rather than as a dividend. Thus, such distributions in contraction of the corporation's business were held to be "not essentially equivalent to a dividend."

The 1954 Code explicitly recognized the concept of a partial liquidation and classified it as a form of liquidation subject to the rules of Part II of Subchapter C rather than as a form of redemption. Furthermore, it gave guidance as to the proper interpretation of a partial liquidation. This guidance was given first in the form of legislative history which indicated that partial liquidations were to be limited to situations in which a portion of the corporation's business was terminated, thus disapproving some cases which under the 1939 Code had permitted the distribution of cash reserves and excess working capital. See generally Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders, ¶9.52 (4th ed. 1979). Second, Congress enacted a safe harbor provision in section 346(b), providing that if a corporation were engaged in two distinct trades or businesses for a period of at least five years, the distribution of all assets relating to one trade or business would be considered a partial liquidation.

H.R. 6295, while abolishing the separate concept of partial liquidations, would also provide that a distribution which satisfies the "two separate businesses conducted for five years" safe harbor now located in section 346(b) would not be "essentially equivalent to a dividend" and, therefore, would be taxed as a redemption, thus preserving capital gain at the shareholder level for some partial liquidations. In a sense, this may be viewed as a return to the basic theory of the 1939 Code that a partial liquidation is merely one form of a redemption, coupled with a transposing of the five year safe harbor from section 346 to section 302. In the interim, however, the Supreme Court's decision in *United States v. Davis,* 397 U.S. 301 (1970), has established that in general only a disproportionate distribution can qualify as not substantially equivalent to a dividend. Thus, the result of converting partial liquidations back into a form of redemption is to elevate the five year safe harbor into the exclusive test of whether a pro rata distribution qualifies as a partial liquidation.

The basic principle that a distribution which is brought about by a substantial contraction of a corporation's business constitutes a form of liquidation is both theoretically sound and equitable. It permits a corporation to expand its business or to explore alternative lines of business without the necessity of forming numerous subsidiaries in order to insure liquidation treatment if it becomes necessary to abandon a portion of the business. The bill essentially recognizes this basic fact by preserving the five year safe harbor as a form of qualifying redemption. However, the five year rule is, as befits a safe harbor, very stringent and was never intended by Congress to repesent the exclusive test for a partial liquidation. The imposition of such stringent *per se* restrictions upon so basic a concept as that of a partial liquidation is justifiable only if it can be shown that the concept is not susceptible to clear definition by administrative and judicial action. Other than a vague and unsupported reference to "undue selectivity" in the Joint Committee Staff Explanation of H.R. 6295, we are aware of no evidence that the partial liquidation concept has been abused.

We would also note that another reason stated for abolishing the concept of a partial liquidation is to provide that distributions will be taxed at the corporate level under section 311 rather than section 336. However, the manner in which the result is accomplished greatly restricts the number of partial liquidations subject to capital gains tax at the shareholder level. If the problem is lack of sufficient recapture at the corporate level (which we do not believe has been adequately demonstrated), it would seem that the least disruptive solution would be to amend section 336, rather than to abolish section 346 entirely.

It has also been suggested that partial liquidations should be abolished because, under the consolidated return regulations, a corporation may obtain a stepped-up basis in assets distributed to it in partial liquidation of another member of the consolidated group whithout triggering immediate recapture of investment tax credits or recognition of gain. At the outset, it is not immediately apparent that this result is incorrect. The investment tax credit is determined solely by the original acquisition basis of qualified property. It does not reduce basis and is not subsequently affected by basis changes. Thus, there would seem to be no reason to require its recapture solely because of a basis step-up. With regard to gain recognition, the lack of immediate recognition is not a "loophole"; rather, the Treasury in promulgating the consolidated return regulations specifically provided for deferral of such gain. If the Treasury now feels this result is inappropriate, it certainly has adequate authority to correct the problem. In general, the Treasury has the broadest possible regulatory authority over the consolidated return area, and it is hard to see how any problems with the regulations could require so drastic a solution as repeal of the partial liquidation concept.

2. AMENDMENTS TO CODE SECTION 311(d)

The second major change proposed in the treatment of corporate distributions is the repeal of most of exceptions to the section 311(d)(1) rule that corporation recognizes gain upon a distribution of appreciated property in redemption of its stock.

The exceptions to be repealed are those relating to the complete redemption of a person who has been a 10 percent shareholder for at least twelve months (section 311(d)(2)(A)), the distribution of the stock of a 50 percent owned subsidiary engaged in a trade or business (section (d)(2)(B)), the distribution of stock pursuant to a court order requiring divestiture under the antitrust acts (section 311(d)(2)(C)), and certain distributions of stock pursuant to the Bank Holding Copmpany Act (section 311(d)(2)(G).

The impetus for this action appears to be a recent series of acquisitions of corporate subsidiaries structured in the form of a purchase of the parent company's stock followed by a distribution of the target subsidiary's stock in redemption of the purchased stock, with the result that the parent company is arguably protected by section 311(d)(2)(B) from recognizing the gain that would have been recognized if the subsidiary's stock had been sold to the acquiring corporation.

Regardless of the merits, if any, of repealing section 311(d)(2)(B) to prevent such transactions, it is difficult to see why these transactions furnish a rationale for also repealing sections 311(d)(2)(A), (C) and (G). The general rule of section 311(a), based on a principle derived from *General Utilities & Operating Co.* v. *Helvering* 296 U.S. 200 (1935), is that a distribution of property by a corporation to its shareholders does not trigger recognition of gain by the corporation. The reason for this rule is that the distributing corporation has merely transferred the property to its ultimate owners and has not realized the property's value. The Tax Reform Act of 1969 added section 311(d) to the Code to require recognition of gain when appreciated property is distributed in redemption of stock, since such a distribution may have the same effect as sale of the property and use of the proceeds to redeem the stock.

Section 311(d)(2) provides seven exceptions to the section 311(d)(1) gain recognition requirement. These exception acknowledge that there are situations in which the general section 311(a) rule of nonrecognition of gain continues to be appropriate. Paragraphs (A) and (B) of section 311(d)(2) deal with major corporate transactions (complete redemption of a 10 percent shareholder and distribution of a 50 percent subsidiary) which represent a substantial contraction of the corporation and are more akin to distributions in partial liquidation which do not result in the recognition of gain at the corporate level. Paragraphs (C) and (G) of section 311(d)(2) are designed to facilitate corporate distributions which effect public policies expressed in the antitrust laws and the Bank Holding Company Act. The reasons for these four exceptions to the rule of section 311(d)(1) remain valid. In addition, even if paragraph (B) of section 311(d)(2) has been subject to abuse, this should not be made an excuse for the repeal of paragraphs (A), (C) and (G) unless it can be shown that those paragraphs also are subject to abuse.

Moreover, the possibility of abuse of section 311(d)(2)(B) does not warrant its repeal even if a narrower approach to guarding against such abuse is possible. The principal objection to paragraph (B) appears to be that the distribution of the stock of a subsidiary to a shareholder who has recently purchased his stock for the sole purpose of having it redeemed is in fact a disguised sale of the subsidiary. The Service and the courts would seem to be adequately equipped with the doctrinal tools necessary to treat such a transaction according to its substance rather than its form. See *Commissioner* v. *Court Holding Co.*, 324 U.S. 331 (1945). In addition, Treas. Reg. § 1.311-1(e)(1) already provides that section 311 applies only to distributions made by reason of the corporate-stockholder relationship.

If it is determined that the substance over form doctrine is too vague to restrain such transactions (although we believe that such a determination would be premature at this time), then additional safeguards could be added to section 311(d)(2)(B) instead of repealing the section entirely. The most obvious approach would be to impose minimum holding period requirements on the stock redeemed as a prerequisite to the applicability of section 311(d)(2)(B). We would note, however, that such requirements would be appropriate only if the redeemed stock is acquired from the corporation, and the consideration paid for the stock is received taxfree as a contribution to capital. If the redeemed stock is acquired by purchase from another shareholder in a bona fide market transaction in which gain is recognized by the selling shareholder, there would seem to be no reason for departing from the rationale of paragraph (B) that the redemption of the purchased stock does not involve a realization of gain at the corporate level simply because the stock was purchased with the ultimate end of acquiring the distributed property.

3. RELATIONSHIP TO SECTIONS 351 AND 355

Title I of H.R. 6295 contains a third provision apparently designed to supplement the provisions discussed above. Under this provision, section 336(a), which provides generally that no gain or loss is recognized to a corporation upon the distribution of its assets in liquidation, would not apply to the distribution of property in liquidation if the distributing corporation within the five years preceding the distribution had either spun-off some of its assets under section 355 or dropped them into a subsidiary under section 351. The apparent goal of this amendment is to avoid indirect partial liquidations through the preliquidation transfer of assets which the shareholders wish to retain in corporate solution. If our reasons for opposing the abolition of partial liquidations are accepted, there will be no need for this amendment. However, even if partial liquidations are abolished, we feel this provision is unnecessarily harsh and imposes substantial restrictions on legitimate corporate transactions.

First, the inclusion of section 355 transactions in this provision is unnecessary. Section 355 is one of the most restrictive provisions of Subchapter C; among other tests, it requires that the subsidiary which is spun-off must have been engaged in a trade or business separate from that of the parent for at least five years prior to the transaction. In addition, a section 355 transaction may not be used principally as a device for the distribution of earnings and profits of either the parent or the subsidiary. These requirements are adequate safeguards against the abuse of section 355 transactions.

Second, although section 351 does not contain the same statutory restrictions as section 355, a section 351 transfer of property to a subsidiary followed by a liquidation of the transferor corporation as part of the same transaction would almost certainly be treated as a section 368(a)(1)(D) reorganization, so that the distribution of the remaining assets of the liquidating corporation would constitute boot and be taxed as such.

Thus, this provision of H.R. 6295 would add to the Code very little additional protection against abuse of such transactions. In addition, it would severely inhibit the use of section 351 to rearrange an affiliated corporate group by making it impossible for five years thereafter to liquidate the corporation involved. Although the bill would permit the Service to exempt "de minimis" section 351 transactions, this would probably be of little use in easing the effect of the rule. The test should not be whether the transfer is "de minimis", but whether it and the liquidation constitute an integrated transaction.

B. Amendments to subsidiary liquidation rules.—The principal effect of Title II of H.R. 6295 would be to revise substantially section 334(b)(2) of the Code dealing with so-called Kimbell-Diamond transactions, i.e., acquisitions of corporate assets by a stock purchase followed by liquidation. Under section 334(b)(2) of the Code, if one corporation acquires 80 percent of another corporation's stock by purchase within a twelve-month period and adopts a plan of complete liquidation of the acquired corporation within two years thereafter, the acquiring corporation receives a stepped-up basis for the assets. The theory for applying a stepped-up basis, rather than the carryover basis which normally applies when a subsidiary is liquidated, is that the real purpose of the transactions was to purchase the acquired corporation's assets. Title II of H.R. 6295 would replace section 334(b)(2) with a new section 338, allowing acquiring corporations to make an irrevocable election within 60 days of the acquisition to treat the acquired corporation as if it had sold all of its assets to a new corporation in a section 337 transaction.

We generally favor this amendment. On a theoretical level, an all-or-nothing contemporaneous election to adjust the basis of assets is more in accordance with the basic rationale of a Kimbell-Diamond transaction than a liquidation which under present law may be initiated within two years and may take an additional three years to complete. Although some cases have applied Kimbell-Diamond to acquisitions taking many years to complete, the proposed election more closely approximates the tax consequences which would normally have obtained if the transaction had been structured as a typical asset purchase. On a practical level, the election obviates the necessity for a liquidation, with the accompanying need to transfer each asset of the acquired corporation, if the acquiring corporation wishes to maintain the acquired corporation as a separate entity. It should, however, be noted that in many cases the acquiring corporation will for business reasons wish to liquidate the acquired corporation, and it should be made clear that such a liquidation does not nullify the section 338 election, even if the new corporation which is deemed to come into existence when the election is made has only a transitory existence.

While we approve of the basic concept of the section 338 election, we recommend the following modifications of the present bill. Again, we note that we have not had sufficient time fully to examine the bill, and these suggestions should not be considered comprehensive or complete.

First, the bill as presently worded applies only to purchases of a corporation's stock by another corporation. While this is also true of the present provision, the reason is simply that section 334(b)(2) is structured as an exception to the general rule of carryover basis in a section 332 liquidation of a corporate subsidiary. Since the section 338 election allows a basis step-up as though the assets were purchased, without the necessity of an actual liquidation, on the theory that the purchaser has in substance purchased the assets, there is no reason that an individual purchaser who could have purchased the acquired corporations through a new corporation or purchased the assets and transferred them into a new corporation under section 351 should not have the benefit of the same election.

Second, new section 338(c) retains essentially the same definitions as are found in present sections 334(b)(2)(E) and 334(b)(3). These definitions have proved highly complex and contain traps for the unwary. We feel that this would be an appropriate occasion for review of the definitions with a view toward simplification.

This is one of the areas in which our previous comment regarding the need for more lengthy review of the proposed bill is particularly appropriate. For example, proposed section 338(c)(3) does nothing to deal with the technical problems which have developed in the definition of "purchase" under present section 334(b)(3). One such problem is illustrated by *Chrome Plate, Inc.* v. *United States,* 442 F. Supp. 1023 (W. D. Tex. 1977), aff'd, 614 F. 2d 990 (5th Cir. 1980), in which the acquiring corporation was denied section 334(b)(2) treatment because, in order to maintain a tiered corporate structure, it transferred purchased stock to a subsidiary before liquidating the acquired corporation. The subsidiary thus technically acquired the stock of the liquidated corporation by contribution to capital rather than by purchase as required by section 334(b)(2). A revision of section 334(b)(2) should encompass a thorough review of the definition of "purchase", rather than simply changing the mechanical operation of the section.

We also feel that any revision of section 334(b)(2) should resolve the issue, which has divided the courts, of whether the section was intended to preempt the judicially developed Kimbell-Diamond rule and provide the exclusive method of obtaining a stepped-up basis in assets through a stock purchase. If the definition of "purchase" in section 338 is thoroughly reviewed and made workable, the election procedure should be final and conclusive, and neither the taxpayer nor the Service should later be permitted to assert a stock purchase in fact constituted an assert purchase.

Finally, we note two technical problems. First, careful consideration should be given to the extent to which a basis step-up is available and appropriate when less than 100% of the stock of the acquired corporation is purchased. Second, the Code at present contains a section 338. Present section 338 merely provides a cross reference to section 312 for adjustments to earnings and profits for distributions in partial liquidation and, of course, should be repealed if partial liquidations are abolished. However, if partial liquidations are retained, a conforming amendment will have to be added to the bill.

C. Toll charge on basis step-up.—Title II of the bill also contains a provision stating general that no step-up in the basis of any asset of a distributing corporation shall be permitted unless the corporation recognizes either all of the "recapture" potential on all of its assets or the recapture and recognition of gain that would have resulted had the distributed asset been sold at its fair market value. This provision raises questions concerning what it is intended to accomplish and how it is intended to work.

The first question is which of the two recapture provisions applies to any given distribution. One possibility is that the taxpayer may be allowed to choose the provision that results in the smaller amount of income to be reported. However, the section does not say so, and since the Treasury is granted the authority to promulgate regulations to carry out the purposes of the section, it could easily take this authority to mean that it may dictate which provision applies in any given situation.

Moreover, the operation of each of the recapture provisions is difficult to understand. The first provision could require a corporation to report all of its recapture potential even though it distributes only a single asset, which asset may itself not be subject to recapture. This seems to be on the face of the provision patently unfair. It is possible that this provision is aimed at "selective" distributions in which a corporation distributes appreciated assets but retains assets with a high recapture potential. However, the only types of transactions which the Joint Committee Explanation asserts can have this effect are partial liquidations and delayed section 334(b)(2) liquidations and the bill already contains substantive provisions dealing with both of these.

The second type of recapture results from treating the distributed asset as having been sold at its fair market value. Under Subchapter C, all property distributed to individual shareholders takes a basis in the hands of the shareholders equal to its fair market value, as does property distributed to a corporate shareholder either in redemption of the distributing corporation's stock or in a non-section 332 liquidation. Proposed section 338, if interpreted literally, would trigger recapture at the corporate level for such distributions. This would seem to repeal virtually all of sections 311 and 336 and overturn General Utilities. However, the report of the Joint Committee Staff does not clearly indicate that so sweeping a result was intended. The exceptions to the toll charge reinforce the confusion. The first exception purports to apply to distributions to "noncorporate distributees". However, this provision cross references only to section 301(d)(1), which applies only to dividend distributions, apparently implying that gain recognition does apply to non-dividend equivalent redemptions and liquidating distributions to noncorporate distributees. The provision then exempts distributions which are presently exempt from the gain recognition provisions of section 311(d). However, since section 311(d) is, itself, an exception to the general rule of non-recognition stated in section 311(a), this again seems to confirm that this section has the effect of overriding section 311(a).

This section appears to have been intended as a stopgap to cover any holes that may have been left in the remainder of the bill. However, on a more fundamental level, it challenges the basic principles of General Utilities which are an integral part of the current structure of Subchapter C. The grant of regulatory authority to the Treasury to implement the "toll charge" could prove to be the basis for further erosions of General Utilities without the benefit of legislative consideration. For example, the bill now says nothing about recognition of corporate level gain on a section 355 spin-off, although such transactions may result in a basis step-up. Does the "toll charge" implicity require, or allow the Treasury to require, gain recognition in such cases? In general, we feel that any sweeping provisions dealing with the basic principles of General Utilities require the fullest possible consideration of the basic structure of our corporate tax provisions, including consideration of a modification of the double tax effect through shareholder-corporate integration, as has been adopted by most other countries with comparable tax systems. We strongly oppose the "toll charge" provisions and recommend, instead, thorough consideration of the other provisions of the bill to eliminate the need for such a stopgap.

D. Revision of tax attribute carryover rules.—Title III of H.R. 6295 represents a new attempt to resolve the continuing problem of revision of Code section 382, dealing with survival of tax attributes in cases of substantial changes in stock ownership. Section 382 was substantially revised in the Tax Reform Act of 1976, without the benefit of public hearings. The numerous technical difficulties and complexities raised by revised section 382 have caused Congress to postpone repeatedly the effective date of the 1976 amendments; they are now scheduled to go into effect in 1984, eight years after their adption. While we approve of any attempt to break the section 382 deadlock, the amendments proposed in H.R. 6295 introduce several new difficulties and do not effectively deal with the problems raised by the 1976 amendments. In particular, H.R. 6295 ignores many of the technical problems and simply refers those problems to the Treasury by a sweeping grant of regulatory authority. We strongly oppose Title III of H.R. 6295 in its present form and recommend that either the subcommittee or the full committee schedule public hearings on the problem of trafficking in tax attributes with a view towards directly facing and resolving the issues raised by the 1976 amendments.

The amendments made to section 382 by H.R. 6295 are the perfect illustration of our general comment regarding the impossibility of adequately analyzing the technical aspects of the bill on such short notice, and the following discussion does not purport to be complete. However, the following are some of the difficulties we see with the proposed revisions of section 382.

The bill would abolish the present distinction between section 382(a), dealing with purchases of stock and section 382(b), dealing with mergers and reorganizations. In its place would be substituted a new integrated "continuing interest factor", designed to measure the decline in interest held by shareholders between the loss year and the carryforward year. The loss carryforward would be reduced by 2½ percent for each percentage point by which the continuing interest factor declines below 60 percent, and would be eliminated entirely when the continuing interest factor drops to 20 percent.

We question whether this integration of section 382(a) and 382(b) is appropriate. Historically, the policy considerations involved in limiting tax attribute carryovers in a purchase of corporate stock have been seen as substantially different from those involved in a merger of corporations. When stock is purchased, the corporate entity remains unchanged. The tax attributes of the corporation may not be utilized by an acquiring corporation unless either a consolidated return is filed (in which case carryover of tax attributes is substantially restricted by the SRLY provisions of the consolidated return regulations) or unless the corporation is merged with the acquiring corporation (in which case the transaction is subject to the restrictions of section 382(b)). This leaves as the only possible form of trafficking in tax attributes in a pure purchase situation the case in which a loss corporation is purchased for its tax attributes and a new business is conducted in the corporate shell. For this reason, section 382(a) has historically required a change in the acquired corporation's business as a prerequisite to the disallowance of tax attribute carryovers. The elimination of the change in business requirement was one of the principal features of the 1976 amendments to section 382(a) and was also a principal target of objections to those amendments. These objections have not disappeared in the past eight years, and we would be opposed to an attempt to reinstate that feature of the 1976 amendments without adequate public hearings on whether the change in business requirements is in fact capable of objective determination and enforcement (although we recognize that some cases have perhaps too narrowly construed a "change in business").

Aside from the issue of whether sections 382(a) and 382(b) should be combined, the manner in which the "continuing interest factor" is defined in the bill raises substantial additional problems. The first problem is that the bill abandons the test based upon the control group of shareholders contained both in present section 382(a) and in the 1976 amendments and substitutes a shareholder-by-shareholder approach. The continuing interest factor in the case of stock purchases is defined as the sum of the lesser of each shareholder's interest in the corporation in the loss year and in the carryover year, except that all shareholders having a less than 5 percent interest are aggregated. The result of this approach is that no credit is given for transfers of ownership among the members of the control group, even though such transactions clearly do not involve a change in effective control or trafficking in tax attributes. To take the simplest possible example, assume all of the stock of the corporation is held equally by two unrelated 50 percent shareholders, and assume that one of the shareholders, who wishes to retire from the business, sells his interest to the other shareholder. The continuing interest factor of the purchasing shareholder would be only 50 percent, and that of the selling shareholder would drop to zero. As a result, the overall continuing interest factor would be only 50 percent and the corporation would lose 25 percent of its tax attribute carryovers, even though this transaction is a very common business situation which cannot conceivably be regarded as trafficking in tax attributes.

The problem is further exacerbated by the fact that changes in the continuing interest factor resulting from reorganizations are determined on an aggregate basis. The bill provides that, in the case of a reorganization, the continuing interest factor of the "new loss corporation" (i.e., the corporation resulting from the reorganization which becomes entitled to utilize the tax attributes) is the percentage of stock in the new loss corporation held by shareholders of the "old loss corporation." When there are changes in stock ownership resulting from both stock purchases and reorganizations, the decrease in the continuing interest factor is the product of the decreases resulting from the purchases and from the reorganizations, which may have an unwarranted multiplying effect. For example, in the hypothetical situation discussed above, assume that after buying out the retiring shareholder, the remaining shareholder decides to merge his corporation with another corporation which is in the same line of business and is owned by a single shareholder. Assume that in the merger each of the shareholders of the two corporations receives 50 percent of the stock of the resulting corporation. As a result, the corporation's continuing interest factor is reduced by 50 percent by reason of the stock purchase and by 50 percent by reason of the merger, for an overall reduction of 75 percent, resulting in an elimination of 87½ percent of its tax attributes. A strong argument can be made that as a matter of policy there should be no elimination of tax attributes in this situation (as there would be none under the current version of section 382), but at the very least it is clear that the maximum reduction of interest with which the corporation should be charged would be 50 percent.

A second major conceptual change in section 382 introduced by the bill is that it takes into account all changes of stock ownership arising between the "midpoint" of the year in which the tax attribute arises and the end of the year in which the carryover period expires. Thus, at present, section 382(a) guards against trafficking in tax attributes by reducing carryovers when a major change in ownership occurs within a defined period of time. H.R. 6295, on the other hand, would require that all changes in ownership taking place over as long as fifteen years (the maximum carryover period for a net operating loss) be taken into account, no matter how small the changes occurring in any given year (or two or three year period) may be. It does not seem that stock acquisitions over such an extended period could be considered the type of trafficking which warrants dramatic revisions to section 382.

Moreover, this approach may cause some disproportionately large reductions in carryovers in later years. For example, assume a corporation incurs a $100,000 net operating loss in year one, and after three years of profitable operation, reduces its NOL carryover to year five to $25,000. Now assume that in year five an unrelated party purchases 50 percent of the corporation's stock. Since a 50 percent decline of continuing interest results under the bill, causing a 25 percent reduction in NOL carryovers, it would appear that the correct result would be a 25 percent reduction in the $25,000 carryover. However, as the bill is presently structured, the corporation would be required to look back five years to the year in which the loss was incurred, and reduce the initial $100,000 loss by 25 percent, causing the carryover to year five to be wiped out entirely.

With regard to the various problems raised by revisions of section 382(b) dealing with reorganizations, there is no comment to be made, because the bill makes no attempt to deal with these issues but merely gives the Treasury a sweeping grant of regulatory authority to prescribe appropriate regulations. The provisions contained in section 382(b) dealing with triangular reorganizations, mergers of affiliated corporations, and so forth are among the most troubling aspects of the 1976 revisions to section 382, and we feel strongly that it would be highly inappropriate for Congress to relegate all of these questions, in which so much public interest has been expressed, to the Treasury. Even if this approach were appropriate, which we do not believe, there would most likely be a substantial period in which no guidance would be available. The experiencee with regulations under section 385 is a case in point.

E. Revised definition of "F" reorganizations.—Section 302 of the bill would amend Code section 368(a)(1)(F) to provide that an "F" reorganization constitutes a "mere change in identity, form, or place of organization of one corporation." The effect would be to overrule cases holding that the merger of commonly owned subsidiaries into a single corporate entity qualifies as an "F" reorganization. We would agree that, as a theoretical matter, the "F" reorganization is most applicable to transactions involving a single active corporation, but we would caution against patchwork amendments to the definitional provisions of section 368 at a time when a major reevaluation of the reorganization provisions of subchapter C is already under way under the auspices of the American Law Institute and the American Bar Association.

The expansion of "F" reorganizations which has occurred in recent years has been largely in response to deficiencies in the remainder of section 368(a). For example, the cases which this bill is expressly designed to overrule reflect the fact that at present there is no provision specifically dealing with divisions and combinations of wholly owned subsidiaries involved in a single business. Such transactions must qualify under one of the general reorganization provisions of section 368(a). Treated as mergers described in section 368(a)(1)(A), they are subject to the limitations on tax attribute carryovers and carrybacks contained in section 381(b). A substantial argument can be made, however, that decisions concerning whether to conduct various aspects of a business in the form of separate corporate subsidiaries or divisions of a single corporation should be made solely on the basis of business factors and that the tax laws should be structured so as not to impede adjustments in such corporate structures. In any event, this is a substantive issue which should be addressed in the context of a complete reevaluation of section 368(a) rather than in a rider to an unrelated tax bill. This is particularly true as there does not seem to be any urgency to the matter, the Service having acquiesced in the expanded definition of "F" reorganizations and published rulings intended to restrict any potential for abuse.

We would also note that the proposed amendment does nothing to resolve other current pending issues regarding the proper scope of "F" reorganizations. For example, when a corporation wishes to redeem the stock of a substantial number of shareholders, it is often more convenient for corporate law purposes for it to merge into a new corporation owned by the shareholders who are to retain a continuing interest. Provided that continuity of interest is maintained, such a transaction is the economic equivalent of a redemption and should have no effect on the corporation's tax attributables. Some courts have recognized this fact by holding that the transaction constitutes an "F" reorganization. See *Aetna Casualty and Surety Co.* v. *United States,* 568 F.2d 811 (2d Cir. 1976); *Reef Corp.* v. *Commissioner,* 368 F.2d 125 (5th Cir. 1966), cert. denied, 386 U.S. 1018 (1967). However, the Service continues to take the position, based upon a statement in *Helvering* v. *Southwest Consolidated Corp.,* 315 U.S. 194 (1942), that any change in stock ownership other than a de minimis change disqualifies the merger as an "F" reorganization. Any reexamination of the scope of section 368(a)(1)(F) should deal with this issue.

II. Antimerger legislation

The four remaining bills under consideration by the subcommittee all have as their common goal discouraging by use of the tax laws large corporate takeovers and mergers. We are, in general, opposed to each of these bills on the ground that the question of whether corporate takeovers are in accordance with the public interest is a matter which should be dealt with under the securities and antitrust laws and not through further manipulation of the tax code. In addition, we have the following comments regarding the individual bills.

H.R. 5517 would amend Code section 279, dealing with the deductibility of interest on acquisition indebtedness, to allow the President to impose a moratorium period of up to two years on such deductibility. During the moratorium period, the present restrictions upon the types of acquisition indebtedness subject to section 279 would be suspended and all acquisition indebtedness would be so subject.

The deductibility of interest in general is one of the basic principles of the Internal Revenue Code. If that principle is to be altered, it should be done through a reasoned examination of the types of interest expense which should be considered either capital items or nondeductible personal items, rather than by utilizing it as an indirect weapon against corporate takeovers. If Congress feels that the President should have the authority to suspend takeover activity, it should grant him that authority directly. We would also note that accomplishing this end by denying the deductibility of interest incurred has a disproportionate effect on corporations depending upon their level of taxable income and accordingly may have an inequitable result.

Two of the bills—H.R. 4562 and H.R. 5855—are identical. Each would deny any deduction for interest on acquisition indebtedness if the acquisition is disapproved by the target corporation's board of directors. All of our objections to the manipulation of the interest deduction discussed above in connection with H.R. 5517 also apply to these bills. In addition, whereas H.R. 5517 would deny the interest deduction when the President determines, presumably on a disinterested basis, that mergers were not in the national interest, these two bills would leave the determination up to the board of directors of the target corporation, individuals likely to be far more interested in preserving control of the target corporation and their own jobs. Thus, the determination of whether the interest involved in a takeover is deductible would be made on a totally unprincipled basis, with regard only to private interest. Not only would this be bad law, but we would question its constitutionality.

The final bill, H.R. 5719, would impose an excise tax equal to fifteen percent of the consideration paid in certain acquisitions of stock or assets, where one of the corporations involved has gross receipts of more than two billion dollars and the other corporation involved has gross receipts of more than three hundred million dollars in the taxable year preceding the acquisition. If the acquiring corporation is owned or controlled by a foreign government, the excise tax is raised to 50 percent.

This bill is in substance a form of antitrust legislation rather than tax legislation and the question of whether it is appropriate for Congress to attempt to discourage acquisitions solely on the basis of the size of the corporations involved through the imposition of a penalty tax is not within the competence of our committee. However, we would note that many of the concepts contained within the bill, such as "the value of all consideration furnished in connection with the acquisition" have potential definitional problems and that the tax may prove difficult to administer. Once again, we suggest that Congress deal with antitrust problems through the antitrust laws and restrict the number of complications added to the Internal Revenue Code to those that are necessary for the administration of the tax system.

FEDERAL HOME LOAN BANK BOARD,
Washington, D.C., May 27, 1982.

Hon. FORTNEY H. STARK,
House of Representatives,
Washington, D.C.

DEAR MR. STARK: On May 6, 1982, you introduced H.R. 6295, the Corporate Takeover Tax Act of 1982, Title III of which would amend present tax law concerning net operating loss and other carryovers. Title III would, apparently inadvertently, delete section 382(b)(7)(B) of the Internal Revenue Code of 1954, which was enacted last year by the Economic Recovery Tax Act of 1981 ("ERTA"), P.L. 97-34.[1] That section affords special tax treatment of net operating loss carryovers in the case of supervisory mergers involving failing thrift institutions by providing that deposits in an acquired corporation which become deposits in the transferee are treated as stock of both corporations, and deposits in the transferee are treated as stock for this purpose. In addition, Title III would amend current continuity of ownership standards concerning the percentage of net operating losses that may be carried over in all mergers or reorganizations, including thrift supervisory mergers. I strongly believe that elimination of section 382(b)(7)(B) and application of H.R. 6295's continuity of ownership provisions to thrift supervisory mergers would not be in the public interest.

I am sympathetic to your desire to ensure that the net operating loss carryover provisions of the Internal Revenue Code reflect sound public policy. However, such amendments would have an extremely adverse impact on the ability of the Bank Board, as the operating head of the Federal Savings and Loan Insurance Corporation ("FSLIC"), to resolve the severe difficulties facing the thrift industry. Specifically, the current tax treatment afforded thrift supervisory mergers provides a particularly cost effective means to avoid otherwise unnecessary liquidations of thrift institutions, to reduce the current pressure on the FSLIC's financial resources, and to protect, depositors in FSLIC-insured institutions. At the same time, such exceptional tax treatment has not, to our knowledge, been abused.

A brief review of the history and rationale of section 382(b)(7)(B) appears useful. On July 23, 1981, I wrote a letter to Senator Rudy Boschwitz (enclosed), seeking his support for an amendment to H.J. Res. 266 that would resolve several technical tax issues that could otherwise hinder the effectiveness of the FSLIC's actions with respect to ailing insured savings and loan associations. Prior to ERTA, section 382 imposed limitations on the use of pre-reorganization net operating loss carryovers where shareholders of the acquired corporation were not shareholders of the surviving corporation in a merger or other reoganization. As a result, there were varying degrees of uncertainty concerning the tax-free reorganization status of various types of supervisory mergers, in particular, mergers of a mutual association into a stock association and mergers of a stock association into a mutual association. The amendment modified section 382 to ensure that losses of weakened associations could be carried over to acquiring entities to the same extent that loss carryovers of other types of businesses can be transferred in tax-free reorganizations.

As I stated in my letter to Senator Boschwitz, the importance of this tax treatment is that it would in most cases significantly reduce the cost of supervisory activities of the FSLIC. Indeed, in some instances, the increased cost of FSLIC assistance, arising, for example, from disallowance of favorable tax treatment of net operating loss carryovers, could cause the cost of FSLIC assistance to exceed the cost of liquidation, thus requiring by statute an otherwise avoidable liquidation. It should be noted in this regard that, to the extent that such favorable tax treatment fosters supervisory mergers of failing thrifts, such tax expenditure is more cost effective than either capital maintenance for thrifts, as embodied in various proposals currently before the Congress, or increased FSLIC assistance in supervisory mergers. In short, my letter to Senator Boschwitz stated my strong belief that the Internal Revenue Code should reflect the extraordinary nature of thrift supervisory mergers, including affording special treatment for net operating loss carryovers of troubled thrifts.

Significantly, there is clear and abundant legislative history illustrating Congress' intent that special tax treatment be afforded to thrift supervisory mergers in order to resolve troubled thrifts' problems and avoid liquidations. For example, the general explanation of ERTA states as follows:

"The Congress believed that recent economic conditions, including high interest rates, have had particularly adverse effects on the country's thrift institutions, which have been the primary providers of mortgage credit * * *. The recent high interest rates have required the thrift industry to pay high short-term rates to depositors; at the same time, substantial portions of mortgage portfolios consist of mortgages paying much lower rates. The resulting losses have threatened the viability of thrift institutions.

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[1] Section 301(a) of Title III provides a new section 382. Although new section 382(f)(8) is identical to current section 382(b)(7)(A), current section 382(b)(7)(B) is deleted. That section currently provides as follows:

(7) Special Rule For Reorganizations in Title II or Similar Cases.—For purposes of this subsection—(B) in a transaction qualifying under section 368(a)(3)(D)(ii)—

(i) A depositor in the transferor shall be treated as a stockholder immediately before the reorganization of the loss corporation;

(ii) Deposits in the transferor which become, as a result of the transfer, deposits in the transferee shall be treated as stock of the acquiring corporation owned as a result of owning stock of the loss corporation; and

(iii) The fair market value of the outstanding stock of the acquiring corporation shall include the amount of deposits in the acquiring corporation immediately after the reorganization.

"* * * [T]he only way to maintain these organizations may be to merge financially troubled institutions into stronger institutions * * *.

"*The Congress concluded that the tax laws should be modified to facilitate * * * mergers of financially troubled institutions into stronger ones.*"

General Explanation of the Economic Recovery Tax Act of 1981 (H.R. 4242, 97th Congress; Public Law 97-34), prepared by the staff of the Joint Committee on Taxation, pp. 151-52 (emphasis supplied).

Senator Boschwitz's statement on the Senate floor introducing last year's amendments similarly illustrates Congressional intent that supervisory mergers of thrifts be afforded favorable tax treatment:

"This amendment would facilitate the infusion of capital to a failing savings and loan or the merger of a savings and loan with another financial institution by clarifying that these transactions are nontaxable events.

"The other alternative to capital infusions or mergers in the case of a troubled savings and loan would be liquidation by the Federal Savings and Loan Insurance Corporation. This would require payment out of their insurance funds to all insured depositors and would have unfortunate results for non-insured depositors. The potential cost to the Government, depositors and shareholders could be significant.

"Under current law, there is some uncertainty about the consequences of * * * mergers of savings and loans. *This uncertainty deters potential investors and will likely result in the more costly liquidation pay outs by the FSLIC.*

"*[S]urely a merger of a failing savings and loan serves the public interest better than liquidation.*" 127 Cong. Rec. S8288 (July 23, 1981) (emphasis supplied).

The rationale for exceptional tax treatment of supervisory thrift mergers remains compelling given thrifts' current earnings crisis. Indeed, because the thrift industry's condition has severely deteriorated since enactment of ERTA, section 382(b)(7)(B) treatment for thrift supervisory mergers is perhaps more justified and necessary today than it was last year.

Finally, to reiterate, please be advised that we have encountered no abuse of this authority. By their nature, supervisory thrift mergers do not present significant problems with respect to tax-motivated takeovers or trafficking in loss companies, which your revision of current law is designed to address. Moreover, the Conference Committee report clearly states the conferees' intent that the requisite certification for the tax-free reorganization and net operating loss carryover treatment set forth in Public Law 97-34 not be made where it is determined that the association has intentionally placed itself in the position where one of the grounds for certification would otherwise apply. S. Rep. No. 97-176, 97th Cong., 1st Sess. at 284.

My second concern with H.R. 6295 is that it would amend the current continuity of ownership standards. These requirements determine the percentage of net operating losses that may be carried over in all mergers or reorganizations, including thrift supervisory mergers. Under current law, loss company shareholders must retain a 20 percent interest in the acquiring association in the carryover year to maintain the full loss carryovers of the loss company, with carryovers reduced by 5 percent for each one percentage point by which the loss company shareholders' interest falls below 20 percent. Under H.R. 6295, however, loss company shareholders must retain a 60 percent interest in the carryover year to maintain the full loss carryovers of the loss company, and carryforwards would be reduced by 2.5 percent for each one percentage point by which the loss company shareholders' interest falls below 60 percent.

The proposed percentages as applied to deposits, including passbook accounts, appear to be unrealistic and unfair in the context of thrift supervisory mergers. Because such mergers, by their nature, normally involve matching a healthy institution with a troubled institution, the retained percentage requirements would generally severely limit the amount of loss carryovers available from the failing thrift. Application of these percentage requirements to thrift supervisory mergers would effectively eviscerate section 382(b)(7)(B), thereby frustrating the important public policy goals which that section was designed to foster.

In closing, I am confident that the tax treatment currently afforded thrift supervisory mergers continues to serve the public interest. Please feel free to contact me or any of my staff if we may be of further assistance to you in this important matter.

Sincerely,

RICHARD T. PRATT, *Chairman.*

Enclosure omitted.

BOSTON UNIVERSITY, SCHOOL OF LAW,
Boston, Mass., May 20, 1982.

HON. FORTNEY H. STARK,
Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, Washington, D.C.

Dear Mr. Stark: I am delighted that your Subcommittee will give serious consideration to legislation relating to tax incentives for corporate mergers and acquisitions. The attention given in your Bill H.R. 6295 to the problem of a step-up in basis in cash acquisitions is well warranted.

I testified on the tax impact on corporate concentration before the Subcommittee on Monopolies and Commercial Law of the House Committee on the Judiciary last fall. I enclose a copy of the testimony. In addition, my recent book, Tax Policy and Corporate Concentration (D. C. Heath and Company 1982) deals in depth with this problem.

I would appreciate obtaining copies of the prepared testimony submitted at your hearing.

Sincerely,

ALAN L. FELD,
Professor of Law.

Enclosure.

TESTIMONY OF PROF. ALAN L. FELD, BOSTON UNIVERSITY SCHOOL OF LAW

My name is Alan L. Feld. I am a professor at Boston University School of Law. I specialize in federal income tax matters.

It may seem odd for a federal income tax specialists to appear at hearings connected with merger policy. Federal tax matters generally have been treated as bearing only to a limited extent on traditional antitrust concerns. For the most part, the influence of federal tax rules has been treated as neutral and as having little influence on corporate concentration or competition.

Based on my own work in this area, I believe the contrary to be the case. Although few provisions of the Internal Revenue Code mention corporate size explicitly, the effect of the tax laws in practice is systematically to encourage concentration and favor large corporations. A few provisions favor small corporations, but their net effect is feeble relative to the main thrust of the federal income tax. The question whether the government should act to curb corporate size has been debated. Few would contend, however, that the government should encourage large corporate size. Yet the tax law appears to do just that.

Some of these points have been developed in three papers prepared for the Federal Trade Commission, two of them with co-authors, Professor Russell K. Osgood of Cornell University Law School and Professor David G. Terkla of Boston University's Department of Economics. These papers are collected in a publication of the Federal Trade Commission entitled Taxes and Competition: Three Analysis (1979–1981). The same theme is expanded and developed in a forthcoming book I have written, Tax Policy and Corporate Concentration, to be published by D.C. Heath & Co. in the Lexington Book series.

Three tax areas illustrate the impact of tax provisions on corporate concentration: The investment tax credit, carryovers of tax benefits and the treatment of retained earnings in acquisitions.

(1) The investment tax credit.—The Internal Revenue Code includes numerous tax subsidies. These provisions aim to induce certain kinds of behavior thought desirable by reducing the tax liability of a particular group of taxpayers. The United States Budget for fiscal year 1981, Table G–1, listed over 90 subheadings for tax expenditures, in amounts that aggregate over $200 billion.

One major tax subsidy for business comes in the form of the investment tax credit, Code sections 46–48. The basic credit, estimated to cost the Treasury almost $20 billion for 1981, allows the taxpayer to reduce his tax liability dollar for dollar by 10 percent of the purchase price of machinery, equipment and other qualifying property. The credit applies in addition to depreciation or other writeoffs of the capital costs of the investment. It is available to corporations generally; size is not one of the factors in the statute affecting use of the credit.

Yet year after year, the largest corporations in the Internal Revenue Service's tabulation obtain a disproportionately large part of the credit. We would expect a corporation twice the size of another to get twice as much credit, but the biggest corporations receive even more. When measured in comparison with net income, corporations in the largest gross asset cateogy, over $250 million, received $4.77 of investment credit for every $100 of net income in 1975, compared to $2.27 per $100 for corporations under $5 million gross assets. The result is that the government gives the largest corporations more tax remission than it extends to smaller ones.

The investment credit also flows disproportionately to particular industries. For 1975 three industries accounted for 37.6% of the credits for all corporations. They were:

Transportation and Public Utilities: Communications, Transportation and Public Utilities: Electric, Gas and Sanitary Services.

Manufacturing: Petroleum (Including Integrated) and Coal Products.

The recipients of the credit are not confined permanently to these industries. If their income is large enough to absorb the credit, (after taking into account other deductions and credits) they may expand into new fields either by direct competition, as AT&T has proposed, or by making acquisitions in new fields.

(2) Carryover of tax benefits.—To mitigate the unevenness of taxpayer income over time, the Code allows a taxpayer to carry many of the benefits it allows forward against future income. The best example of the carryover provisions does not derive from a tax subsidy, but from the net operating loss provisions. If a corporation incurs more deductions than income in a particular year, Code section 172 allows it to carry the excess back so as to offset income of earlier years, then forward. As a result, a history of losses can render a corporation more valuable, if those carryovers can be brought into conjunction with profits. The profits can be enjoyed essentially tax-free.

The tax law thus creates a valuable tax incident for corporations that cannot absorb deductions currently. Similar provisions apply for certain other benefits, such as unused investment tax credits or foreign tax credits, Code sections 46(b) and 904(c). In some cases, the same conditions that limit the current use will mean that the corporation will not be able to absorb these benefits in the future. The shareholders may try to sell their corporation to another corporation in order to realize something on tax benefits. To illustrate, suppose *A* corporation, which has high income, would pay $2 million to acquire the business of L corporation. If L also has $1 million of loss carryforward it can protect $1 million of future profits from tax, a benefit worth potentially $460,000. *A* might pay L's shareholders an extra $100,000 to obtain the use of L's losses. The Code has a number of provisions that regulate "trafficking" in losses and other tax benefits,[1] yet corporate planners often can arrange to transfer them successfully.

Thus, the tax law creates an incentive to combination when it confers a tax benefit that the corporation cannot digest currently but that remains available to reduce future corporate tax.

3. The Treatment of Retained Earnings in Acquisitions.—The tax Code creates incentives that help an acquiring corporation to buy a target corporation using its own accumulated earnings. This result follows from two sets of rules.

First, individual shareholders include dividend distributions from their corporation as ordinary income.[2] Retained earnings of the corporation or increases in the value of its assets are not included in shareholder income. When a shareholder sells his stock, the price reflects both the accumulated earnings and the increases in underlying asset value. If the shareholder holds the stock over a year, gain on the sale enjoys long term capital gain treatment. But the retained earnings represent potential dividends, so that if the buyer is another individual and the corporate business continues, the buyer faces the same ordinary income tax potential on distribution of earnings.

Second, corporations incur either low tax or no tax on dividends. Under Code section 243 a corporation may deduct 85 percent of any dividend received, and 100 percent of a dividend from a member of an affiliated group. Moreover, if a corporation buys stock of another corporation and liquidates it, the purchasing corporation incurs no tax on the target's assets through a new, fair market value basis.[3] The target corporation meanwhile incurs little or no tax on the liquidation.[4]

When we consider these two sets of rules together, their influence on corporate acquisition can be seen. The tax law first encourages individuals to have their corporations retain earnings rather than distribute them. Then it encourages sale to corporate purchasers, which can extract the accumulated earnings without tax, rather than to individuals.

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[1] See Code sections 269, 382, 383 and 482.

[2] A relatively small dividend exclusion is provided under Code section 116 and will be ignored in this discussion.

[3] Code section 334(b)(2).

[4] See generally Code section 336.

This pattern can be compounded when the purchaser-corporation borrows the purchase price. The interest is deductible.[5] The purchaser may pay the interest with tax-free dividends from the target corporation. One dollar of tax-free dividend covers $1.85 of deductible interest. In effect, the purchaser can use the target's own accumulated earnings to pay part of the purchase price, reaching cash or other assets of the target corporation at lower tax cost than the original shareholders could.

These three examples show how tax provisions that appear neutral on their face can effect corporate size and structure. Federal tax rules touch virtually every economic decision within our society. Perhaps more important than pointing to any particular provision that affects corporate concentration, I would underscore the general point, that taxes play a significant role in shaping a favorable business environment for large-sized corporations. To assure a fairer and more even-handed tax system, those concerned about monopoly and concentration must examine more closely the operation of the tax system as it confronts business, must identify the harmful provisions, and must advocate changes that support competition.

STATEMENT OF ALBERT A. FOER, WASHINGTON, D.C.

My name is Albert A. Foer, and I am an attorney with the Washington, D.C. firm of Jackson, Campbell & Parkinson, P.C. These comments are my own. They represent neither a client position nor a position of my former employer, the Federal Trade Commission (FTC). I departed the Commission in November, 1981. Among my responsibilities as the Bureau of Competition's Assistant Director for Special Projects were several "think tank" activities involving the relationship between tax policy and competition policy. Although this work was brought to an abrupt halt with the change of Administration, I think it is important for your Committee to be aware of the work that was done and the directions in which it was moving.

I. Introduction

The Taxation and Competition project, P810043, was one of a series of interrelated undertakings at the FTC in the years 1977-81 designed to investigate the dynamics of competition from a multidisciplinary perspective.[1] This included projects concerning capital markets, business strategic behavior, emerging industries, innovation and mergers. In most instances, we had to struggle to translate the learning from other disciplines to the needs of antitrust and competition policy. By contracting with tax, finance, economics and business school professors, we greatly speeded this difficult process. Where we were successful in integrating relevant knowledge, the result has been a much fuller understanding of the competitive process.

I believe we completed sufficient work on these diverse topics to identify preliminarily two effects of the existing tax structure that may have major impact on the process of competition:

"Because of the tax laws, larger diversified firms tend to have lower costs of doing business than smaller, newer, single line firms.

"The structure of tax laws tends to encourage large diversified firms to acquire profitable (or potentially profitable) smaller, newer, single line firms, among others, by effectively subsidizing the acquisition."

These two effects create artificial tendencies toward economic concentration and lessen the natural reinvigoration of the marketplace through the emergence of innovative or aggressive new competitors. If we were correct (and I stress that we had only been able to present a series of hypotheses in need of empirical verification), the American tax structure helps skew the competitive process in a way that counters the Schumpeterian concept of capitalism as an engine of creative destruction: that is, the tax law discriminates against new innovative single product firms and in favor of established diversified firms which may be less efficient.

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[5] Section 279, which limits deductability of some acquisition interest, is narrowly drawn and often will not apply.

[1] A substantial group of talented individuals was assembled to work on the tax project. The attorneys most involved in the FTC's Bureau of Competition were Kenneth Davidson, Deputy Assistant Director of the Office of Special Projects, Kenneth Miller (now practicing with the Boston firm of Berman, Dittmar & Engel), Allen Larson, and Paul Davis. In the FTC's Office of Policy Planning, Thomas H. Stanton, Deputy Director, was in charge of tax-related projects. In the FTC's Bureau of Economics, economists Ronald Lafferty and Marvin Rosenberg participated on the tax projects. Both the Office of Special Projects and the Office of Policy Planning were abolished by Chairman James Miller. As far as I know, the agency has no tax-related work in progress. This statement is not intended to reflect the views of any of the above-named individuals.

II. History of the FTC's tax project

Prior to the initiation of the tax project by the Office of Policy Planning (OPP) and the Bureau of Competition's Office of Special Projects (OSP) in May 1978, most attention in the tax/competition area had been focused on merger incentives[2] and to a lesser extent on incentives to corporate growth through retained earnings.[3] OSP and OPP started with a broader inquiry on the effect of taxation aggregate concentration through a series of contracts with Professor Alan Feld, a tax law professor at Boston University Law School and his associates.[4] The Small Business Administration's Office of Advocacy more or less contemporaneously commissioned a similar study with Professor Steven Vasek of the University of Kentucky.[5] At the same time, OSP began a series of more narrowly focused tax projects: a contract with Merrill Lynch Econometrics to model the impact of tax law on mergers; a contract with Professor William Beazer to identify the sources of growth in firm value; a contract with Professor Alan Auerbach to profile the tax characteristics of shareholders (ultimately entered into by the Small Business Administration); and internal research by then staff attorney Kenneth Miller modeling the effect (if any) on a firm's overall cost of capital of the availability of retained earnings, and analyzing the competitive impact of legislative tax proposals.

The results of the Feld and Vasek work which examined aggregate data collected by the IRS mildly supported the thesis that tax laws promote aggregate concentration, but the kind of data and the way it was used did not focus on the competitive dynamics of tax effects. Moreover our research on mergers and aggregate concentration indicated that there was not a discernible trend toward aggregate concentration.[6] And our studies of merger motives suggested that tax considerations were not an important independent merger motive.[7]

On the other hand, we developed a different perspective on mergers and competitive interaction through work on innovation, capital markets and business strategy. Work on innovation [8] and business strategy [9] convinced us of the critical importance of new and emerging firms to the development of new products and elimination of so-called x-inefficiency.[10] We began to examine the capital markets with a competitive paradigm that included product and firm life cycle concepts and internal capital allocation systems using product portfolio matrices.[11] Accordingly, our exploration of the capital markets began to shift focus from large/small comparisions to the relative availability of capital to new small single line firms as compared to large established diversified firms with retained earnings. This in turn led back to tax issues: whether there is a tax incentive to retain earnings and whether the implicit cost of retained earnings and whether the implicit cost of retained earnings is less than that for external capital.

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[2] The primary topics were loss carryovers, stock for debt switches and the desire for owners of small businesses to obtain liquidity through tax-free reorganizations. See, e.g. J. Hellerstein, "Mergers, Taxes and Realism" 71 Harv. L. Rev. 254 (1957) and W. Lovett, "Tax Subsidies for Mergers" 45 N.Y. U. L. Rev. 844 (1970).

[3] See, e.g., M. Friedman, "Capitalism and Freedom" p. 130 (1962) and H. Simons, "A Positive Program for Laissez Faire" in "Economic Policy for a Free Society" (1948).

[4] A. Feld, D. Terkla and R. Osgood, "Taxes and Competition: Three Analyses," prepared for the Office of Policy Planning, FTC (1981). Professor Feld recently published an expansion of this titled "Tax Policy and Corporate Concentration" (D.C. Health, 1982).

[5] "Tax Law Effects on Business Concentration" prepared for the Small Business Administration SBA-2651-0A-79 (1981).

[6] See, e.g. the statements of Alfred F. Dougherty, Jr. and William S. Comanor before the Senate Committee on the Judiciary Hearings on S. 600, 96th Cong. 1st Sess. Pt. 1. Later data, encompassing the most recent merger wave, may show that there is more of a trend toward aggregate concentration. According to statistics used by the FTC in December 1981, there had been a 3.2 percent increase in aggregate concentration in the manufacturing sector from 1974 to 1980. This was before the jump in activity that occurred in 1980, 81, and 82. See attachment.

[7] See, W. Boucher, "The Process of Conglomerate Mergers" prepared for the Bureau of Competition, FTC, 1980 at p. 78-9; and W. Carlton et al, "An Empirical Study of Merger Motives" prepared for the Bureau of Competition, FTC, 1980 at p. 23.

[8] See, e.g., J. Hilke and C. Goldfarb, "The Relationship Between FTC Activities and Private Sector Technological Growth'" (memorandum October 16. 1978).

[9] "Selected Readings on Strategic Planning by Businesses, Office of Special Projects, Bureau of Competition, FTC (unpublished) January 1981.

[10] See H. Leibenstein, "Beyond Economic Man: A New Foundation for Microeconomics" (1976) which describes x-efficiency (the waste that comes with not having to compete vigorously) in terms of the amount of effort expended by individuals and organizations.

[11] E. Morrison and R. Craswell, "Paprs on Business Strategy and Antitrust," Office of Policy Planning, FTC, September 1980; K. Davidson "Looking at the Strategic Impact of Mergers" 2 "Journal of Business to Strategy" 13, Summer 1981.

III. The Focus Evolves

One part of the FTC's focus evolved to an exploration of whether the tax laws disadvantage the most dynamic element in the market: the emeraging firm. Many of us came to believe that the tax laws do disadvantage such firms although there was no opportunity to estimate the magnitude of the handicap imposed on the emerging firm. Three aspects of the tax laws tend to create the competitive disadvantage:

1. the system of deductions and tax credits;
2. the tax incentive for corporations to retain earnings; and
3. the lower tax imposed on income from the sale of capital assets.

DEDUCTIONS AND CREDITS

New and expanding firms tend to have a negative cash flow. Unlike firms with a positive cash flow, they cannot currently fully utilize their tax credits and deductions. Accordingly, an expanding single line firm incurs higher operating cost than a profit making diversified firm which is engaged in identical activities. The diversified firm can finance, using deductions and credits, the expansion from pretax (or untaxed) income, whereas the new single line firm must obtain already taxed external capital.

This is not a new insight. The tax carryover provisions were enacted to permit deductions in future years (if the firm become profitable) to provide some degree of equality of treatment. (Note however that the discount rate, which includes inflation, rapidly diminishes the value of future deductions.) Indeed those who seek to promote innovation by small firms have argued that new firms should be entitled to a longer carry forward period in which to realize the value of their deductions.[12]

What does not seem to have gained attention are the competitive implications of the differential tax burden. For example, a firm which wants to and could produce an item more efficiently would be unable to sell it for less because unlike its established competitor, it would have to finance its operations from taxed dollars. This raises problems of entrepreneurial opportunity and equality of treatment; it severely diminishes forces counteracting the x-inefficiency of large established firms.

RETAINED EARNINGS

It is generally accepted that the tax laws create an incentive to retain earnings rather than distribute them as dividends to shareholders. It is, however, a matter of some dispute whether the availability of retained earnings lowers a firm's overall cost of capital.[13] If retained earnings lower the firm's cost of capital, then the competitive implications are similar to those arising from the differential impact of deductions and credits discussed above; i.e., the established firm can carry one its business more cheaply than its newcomer competitor, as a result of tax-related factors that don't relate to efficiency.

To determine the differences (if any) in cost of capital for firms with retained earnings is an extraordinarily complex undertaking. Before he left the Commission, Ken Miller began work on a methodology which we though went a long way toward establishing the nature of the differential. His work attempts to prove theoretically that firms with retained earnings have a lower cost of capital. Unfortunately, the work did not progress beyond a draft stage, and was in need of substantial evaluation and editing when the project ended.

CAPITAL GAINS

The existence of favorable rates for capital gains appears to provide, in effect, a subsidy for firms to acquire profitable firms. This arises because the value of the target firm to its current shareholders is (generally) the discounted value of future dividends which are taxed at ordinary income rates. The sales price of shares is normally (ignoring tax free shareholders, stepped up basis at death and dissolution) constrained by the fact that the value of the future stream of earnings to the buyer will also be diminished by ordinary income treatment.

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[12] See, e.g., J. Cordes, "Economics and Tax" in "Industrial Innovation and Public Policy Options" (National Academy of Engineering 1981).

[13] See, e.g., Baumol, et al., "Earnings Retention, New Capital and the Growth of the Firm" 52 *"Review of Economics and Statistics"* 345 (1970); Whittington, "The Profitability of Retained Earnings" 54 "Review of Economics and Statistics" 152 (1972); and Grabowski and Mueller, "Life Cycle Effects on Corporate Returns and Retentions." 57 "Review of Economics and Statistics" 400 (1975).

However, in a takeover transaction the buyer can use the retained earnings of the target to (in part) pay off the target firm's shareholders. Because the target shareholders are given capital gains treatment on this money which otherwise would have been distributed as dividends, there is less tax paid. The difference in tax liability is a subsidy to the takeover transaction. This gift of what otherwise would have been treasury funds can be split between the acquiring frim and the target firm's shareholders. To the extent that the acquiring firm obtains the benefit, it lessens the cost of acquisition.

This rate differential applies to a target firm's prospective earnings as well as to its past retained earnings. The acquiring firm pays off the target's shareholders at capital gain rates for share interests that have ordinary income constraints on their value.

Accordingly, the more profitable a firm has been (or will be) the greater the subsidy. This conclusion contrasts with and complements traditional literature on tax incentives to merger which has emphasized the incentive to merge with unprofitable firms because of tax loss carryovers. This analysis suggests a different and more complex profile.

TAX INCENTIVES TO MERGE

The implication of this is that the tax incentive to merge applies with greatest force to profitable firms, past and future. For established firms with large retained earnings, the acquiror can use those earnings and the rate differential to pay off the target's shareholders. (In effect the transaction become a partial liquidation.) Even more significant from a competition policy point of view is the takeover of emerging firms with high profit potential.

The apparently successful new or emerging firm is an ideal tax target for takeover. The acquiring firm can buy at capital gains rates the ordinary income expectations of the target's shareholders. In addition, the acquiring firm can deduct unused loss carryovers and credits against its income which were diminishing in value in the target's hands. Furthermore, it can operate the emerging firm at a lower cost due to tax laws by currently deducting in full its expenses and credits and by its (arguably) lower cost of capital due to retained earnings.

If this profile is accurate and accounts for a substantial number of acquisitions, it has fundamental significance for competition policy and industrial organization. It stands on its head the conventional wisdom about the market for corporate control [14] by creating an incentive for taking over able managers rather than poor managers. It suggests a governmentally created tax bias in favor of aggregate concentration. It may also suggest explanations why larger firms may be able to continue to grow despite lesser efficiency than smaller newer firms and why acquiring firms may be able to maintain their profitability despite paying large takeover premiums.

IV. Conclusions

The FTC staff work on the relationship between taxation and competition suggests the importance of integrating tax policy, competition policy, and strategic thinking. Policy makers have not always been sensitive to the need for such integration. For example, while entrepreneurs were complaining about their inability to obtain venture capital, high capital gains tax rates (relative to recent reductions) discouraged investment activity. While strategic thinkers have advised small firms to emphasize innovation and market segmentation, such actions are discouraged because research and development expenses (which large firms may deduct and pay for out of pretax dollars) tend to be paid for by small firms out of taxed dollars. And while the Economic Recovery Tax Act of 1981 extended loss-carryover provisions in part to provide small firms more time to bring innovative ideas to commercial success, the problem remains that the small firm may not survive in its early years to take advantage of these provisions, which by the time they are usable will have lost much of their value due to inflation and the time discount value of money. More to the point, perhaps, are the provisions allowing sale of current tax deductions and credits. Whatever the merits of such provisions for inefficient or failing firms, sale provisions are a vehicle to reduce the tax induced disparity in operating costs between innovative single product growth firms and established diversified firms.

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[14] See, e.g., H. Manne, "Mergers and the Market for Corporate Control" 73 Journal of Political Economy 110 (1965).

These comments do not address the particular bills before the Committee. I am delighted that Congress recognizes the important linkages between taxation and competition. While the linkages are complex and barely understood, this has as much to do with the fact that few resources have been devoted to the problem, as with the innate difficulty of the task.

Bringing tax and competition policy into conjunction is more important than ever before, for several reasons. First, federal antitrust policy has fallen into the hands of people who hold the free market in unusually high regard. But the market works within an institutional context, and if the context somehow skews the results, there is no reason why we should accept all market outcomes as natural and therefore desirable. To the extent that mergers result from tax policies, we should not be comfortable with rationalizations that mergers would not occur unless they increased the economy's efficiency.

Second, tax policy may in fact supply an alternative to antitrust for structuring industrial behavior and organization. Properly used, it could foster more innovation and less concentration without the harshness and post-hoc interference that sometimes characterizes antitrust.

Finally, however, I have to say there is much learning to be done. Once the FTC staff learned how little was known in this area, we developed a two-pronged long-range agenda. First, we wanted to encourage law school professors and economists to become comfortable with crossing the border between tax and antitrust. With the publication of Professor Feld's book, "Tax Policy and Corporate Concentration," and the hope that it will generate academic discussion of a high level, we may have achieved much of that goal. Second, we wanted to convince Congress that tax policy and competition policy are so intimately related that efforts should be made to think of the two together, in order to avoid inconsistent policies and to develop the ability to use the best tool for a given end. With these hearings, a beginning is being made. I hope that competition policy will be an integral part of your deliberations on the tax laws.

LAVENTHOL & HORWATH,
CERTIFIED PUBLIC ACCOUNTANTS,
Washington, D.C., July 14, 1982.

Re Corporate Takeover Act of 1982 (H.R. 6725).

Hon. DAN ROSTENKOWSKI,
Chairman, Ways and Means Committee,
Washington, D.C.

DEAR MR. ROSTENKOWSKI: We are writing to express our views on the Corporate Mergers Bill. At the outset, we wish to congratulate the Congress for its prompt action in attempting to close "loopholes" which threaten the integrity of our tax system. There is a danger, however, that Congress' legislative response to the activities of some very large corporations will have a severe adverse impact on this Nation's smaller corporations. Small to medium size corporations, which constitute the bulk of our clientele, provide millions of jobs and pay billions in taxes. These corporations, while almost never in the position to participate in the abuse transactions described in the Bill, are the most likely to be hurt by an overreaching Congressional remedy of those abuses. Our specific comments follow.

PARTIAL LIQUIDATIONS

The Bill is designed to prevent tax abuse arising through the purchase of stock followed by the partial liquidation of the purchased corporation. This technique, because of an exception from the recapture provisions contained in the consolidation return regulations, permits a corporation to buy assets from another corporation with a step up basis to the purchasing corporation and no recapture to the newly acquired subsidiary corporation. The repeal of all or part of section 346 will stop an abuse by a handful of corporations to the great expense of thousands of corporations. Many corporations undergo partial liquidations for valid business reasons in which tax avoidance plays little or no role such as when a factory building is destroyed by fire. Since, in some cases, the business destroyed by fire, etc., is not yet five years old, the imposition of a five year rule can also work a hardship in a non-abuse transaction. Instead of repealing a non-abuse oriented provision which has been in the Code for many years, serious consideration should be given to the simple solution to the problem, namely revising the consolidated return regulations. Those regulations could be amended to treat distributions in partial liquidation as events to which the recapture rules apply just as they apply to distributions in complete liquidations where the basis of the assets is determined under section 334(b)(2).

SECTION 311: TAXABILITY OF CORPORATION ON DISTRIBUTION

One of the techniques touted for acquiring a corporation with zero tax liability to all parties involves the purchase of a parent corporation's stock followed by the complete redemption of that stock using the stock of a 50% or greater subsidiary. Because of the abuse, Congress is proposing to repeal the exception from the recognition rules of section 311(d). We believe that this will have an unjustifiably harsh impact on small corporations.

First, the technique of acquiring a corporation through the purchase of its parent's stock implies a hastily carried out transaction. The reason for the haste is that no corporation wishes to have a new shareholder, possibly with adverse interests, holding its stock for more than a brief instant. The problem being addressed by the Congress can be solved not by repealing section 311(d) (2) (B) but by imposing a two or three year minimum time period during which the non-recognition provisions of section 311(d) (2) (B) will not apply.

Second, we believe that the repeal of the non-recognition provisions of section 311(d) (2) (A) would have a severe negative impact on small corporations and should be deleted from the Corporate Mergers Bill. It is common for a corporation to redeem one or more shareholders other than on death. All too often, valid business reasons dictate that the redemption take place on short notice. When this occurs, small corporations often find themselves without sufficient cash to redeem a shareholder. Sometimes it is not possible for the corporation to issue debt instruments in a redemption transaction because of the corporation's already high debt to equity ratio. In these circumstances, corporations often must resort to the use of appreciated property to redeem shareholders. If the exception from the recognition of gain was repealed, thousands of corporations with inadequate funds would be forced to pay burdensome taxes upon the redemption of shareholders. For this reason, we urge your committee and the Congress to reconsider penalizing small corporations in an attempt to deter tax schemes by a handful of very large corporations.

Your consideration of these comments will be greatly appreciated.

Respectfully submitted.

PAUL BRODERICK,
Office of National Tax Services.

STATEMENT OF R. A. CAPONIGRO, SENIOR VICE PRESIDENT OF FINANCE AND TREASURER, THE STROH BREWERY CO.

A SPECIFIC SHORTCOMING IN H.R. 6295

The Stroh Brewery Company, an Arizona corporation submits the following statement in the belief that the sponsors of H.R. 6295 did not intend to give that legislation retroactive effect. In certain situations, however, that unfair effect will ensue.

The sponsors no doubt thought they were avoiding retroactivity by, illustratively in Title I, making it expressly applicable only to "distributions occurring after August 31, 1982" (¶106.) to the same end, future dates also were chosen with respect to the other sections of the bill. Nevertheless, retroactive effect will ensue, and unfairly so, in the case of transactions which (i) though in form not to be consummated until after the express effective dates, (ii) will be carried out at that point only because of binding arrangements (or court decrees) entered into before that date.

In all fairness, tax legislation (rates aside) should not be retroactively applied in such circumstances, given the fact that certain prices will have been set on the basis of earlier existing law (including tax law) and, in our case, where change in the earlier law could not then even have been anticipated.

While the retroactivity problem is easily recognizable in simple situations, it is extremely important for the Subcommitee to understand the essential facts of our more complicated situations, for only then can it also see that retroactivity itself, and its unfair effects, also can ensue from an aggregate of complicated circumstances and even affect, as in our case, transactions which were clearly pro-competitive, and, thus, clearly in the public interest.

In short, the retroactive effect here emerges only as the end result of several related and completely constructive transactions, some of which were consummated recently with yet others to be consummated—pursuant to existing arrangements—in the not distant future though necessarily after the effective dates now set forth in the proposed legislation.

FACTS OF THE ILLUSTRATIVE CASE INVOLVING THE STROH BREWERY CO.

Traditionally, among corporations engaged in the production of beer, The Stroh Brewery Company has been a regional concern selling only in certain states East of the Mississippi, in contrast to the two giants of the beer industry, Anheuser-Busch and Miller Brewing Company who produce and market their products throughout the entire country, together accounting for approximately 52% of national sales—which figure continues to increase annually, while the shares of rivals correspondingly diminish in the face of the nation-wide promotional efforts of these concerns.

Stroh Management has not been alone in believing that such trends threaten the very continued commercial existence of the so-called regional producer and that Stroh was not likely to survive in the long run unless larger markets could be secured, and efficiencies in them could be sustaintially improved; and this was possible only if efficiencies of scale could be achieved, with costs (advertising, etc.) spread across a truly national market as the industry's two giants have done.

Examination of the industry reflects both the steady elimination of regional producers of limited competitive abilities and combination of those whose franchises, although not sturdy enough to stand alone, were sound enough to enable them to continue in combination with other brands. Having been in the brewing business for over 200 years, the Stroh family did not wish to limp along until Stroh too would become an industry statistic in this manner and sought instead to transform it into a nationwide producer competing head-to-head with the industry leaders on a more equal footing.

To help achieve this objective, Stroh has managed to obtain financing for $340 million which, with other funds, would enable it to acquire Jos. Schlitz Brewing Co., the breweries of which were located in parts of the country where Stroh had none.

The question of whether to try to acquire Schlitz was controlled solely by non-tax business and economic considerations. The actual price which Stroh was willing to pay, however, necessarily (in this real world) had to be responsive to all economic factors of which the tax aspect—based on then existing tax law—clearly was one, albeit only one of many. Equally important in recognizing the existence of the retroactivity problem in our case is the further fact that Stroh also knew at that earlier point in time when it acquired Schlitz for a given price that Stroh was bound for two unrelated reasons to dispose of at least certain components of Schlitz as soon thereafter as possible and in any case within 24 months.

The first and legally less compelling reasons had to do with the bank loans. To obtain those, Stroh had to demonstrate to the bankers that it could produce not only the balance of the necessary acquisition funds, but also could repay a substantial part of the enormous loan within a relatively short period. Thus, as of the time of the acquisition, Stroh knew that it would have to dispose of certain of Schlitz's producing units.

For what it is worth, such disposition also is pro-competitive and in the public interest, since the acquiring regional producers will be strengthened thereby. There never was any thought that the components in question would or could be sold to one of the industry's two existing giants. Such a sale would be against Stroh's own interest and, in any event, because clearly anti-competitive, would be precluded by the Department of Justice.

A second and more important reason—a *legal* imperative—why Stroh, on acquiring Schlitz, knew that thereafter Stroh would have to dispose of one of Schlitz's major producing units involves the so called "Southeast Market". This consists of Florida, Georgia, Kentucky, Maryland, North Carolina, South Carolina, Tennessee, Virginia, West Virginia and the District of Columbia. Of Schlitz's five scattered breweries, three (plus two can-producing units) are in that one region. The Department of Justice clearly did not think in general, that Stroh's acquisition of Schlitz would be anti-competitive. Indeed, except for the Southeast Market, the acquisition of Schlitz by Stroh was not merely "competitively neutral" but also actually "may be pro-competitive".[1] However, as to the effect on the before-mentioned Southeast Market, where Schlitz had three of its five brewery units, the Justice Department conditions approval upon Stroh's agreeing to dispose of one of the two brewery units located in Winston-Salem, North Carolina and Memphis, Tennessee, respectively. Accordingly, at that point (back on April 16, 1982) Stroh entered into a consent decree (United States District Court for the District of Columbia, Civil Action No. 82-1059) agreeing "absolutely and unconditionally" to divest itself, following its acquisition of Schlitz. of the equity interest, direct or indirect, in one of the two beforementioned Southeastern breweries. This divestiture, involving as it might well over $125 million, must be accomplished, according to the decree, within 12 months and, failing that, a trustee is to be appointed with power to effect the disposition over the succeeding 12 months.

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[1] See p. 7 of the consent decree cited infra. Such disposition has a further pro-competitive public interest by-product since by Justice Department decree, neither of the two Southern brewery components in question, Memphis or Winston-Salem, can be sold to Anheuser-Busch or Miller. The acquiror, particularly if it is a regional concern, in purchasing a sound well-positioned plant in a strategic, fast-growing market can only increase competition there.

THE CONSEQUENT IMPACT OF H.R. 6295'S ADVERSE RETROACTIVE EFFECT ON THE STROH BREWERY CO.

Observe from the foregoing fact that The Stroh Brewery Company, before the introduction of H.R. 6295 and in response to all economic considerations including tax factors and tax arrangements available under the then existing tax law:

(i) Had agreed to pay a given price (fixed by reference to those total economic considerations) for an indirect equity interest in Schlitz's producing units, and;

(ii) Had then also agreed with the Justice Department to turn around and dispose of certain major units with an estimated value (in part because of then existing tax laws) of over $125 million.

In reaching those agreements, Stroh had obviously and justifiably assumed that the then existing law (including the then existing tax law) would apply to the dispositions to which it then committed itself, just as it would apply to the acquisition to which it then also had committed itself.

In short, in a practical sense, The Stroh Brewery Company, though subject in the interim to normal risks associated with equity ownership, was otherwise simply a conduit with respect to those particular producing units as to which it had agreed, on buying, also more or less immediately to sell. To apply one tax law to the acquisition but a different and less advantageous set of tax laws to a disposition to which Stroh earlier also had committed itself obviously generates as to the second required step the unfair effect of retroactivity. Since there was no real time span between the two agreements (acquisition, and the agreement to dispose), to apply a different tax law to one of such agreements makes no sense. Indeed, the retroactive effect here will be as unfair as the application of the proposed legislation to an early 1982 binding contract between and actual acquiring and an acquired corporation where final consummation of the contract is to take place shortly after the effective date of the proposed legislation.

PROPOSED AMENDMENT OF THE EFFECTIVE DATE PROVISIONS

In all fairness, the effective date provisions should be amended so that the existing tax law will be left applicable not only to binding contracts between sellers and buyers when entered into before September 1, 1982, but also to dispositions which take place thereafter but are in furtherance of and pursuant to consent decrees entered into with the Department of Justice prior to September 1, 1982 or where there are binding contracts which, as in the present instance and given the financial arrangements pertaining to an acquisition predating the effective date of this act, anticipate, and as a practical matter, make highly probable the prompt disposition of acquired assets.

The Stroh Brewery Company is deeply appreciative of this opportunity to highlight the one shortcoming in H.R. 6295 with which it quite legitimately is most concerned.

Tax Executives Institute, Inc.,
Arlington, Va., May 24, 1982.

Re Corporate Takeover Tax Act of 1982.

Hon. Dan Rostenkowski,
Chairman, House Committee on Ways and Means,
Longworth House Office Building, Washington, D.C.

Dear Mr. Chairman: Tax Executives Institute, Inc. ("TEI") is an organization with approximately 3,800 individual members representing over 1,100 of the leading corporations in North America. Membership in TEI consists of persons employed by corporations who are charged with the administration of the tax affairs of their employers in an executive, administrative or managerial capacity.

TEI would like to take this opportunity to comment of H.R. 6295, the Corporate Takeover Tax Act of 1982, which was introduced on May 6, 1982 by Representative Stark of California. While TEI expressly is not taking a position regarding the advisability of anti-takeover legislation, we would like to comment on what we perceive to be certain administrative and technical deficiencies in the language of the proposed legislation. Although we agree with Representative Stark that the tax system should be neutral with respect to corporate takeovers, we have serious reservations about the content of his bill and believe that it merits serious reconsideration. In the first instance, some provisions of the bill are overly broad in that they attempt to remedy perceived abuses produced by the interrelationship of complex provisions of the Code by simply excising entire Code provisions. These Code provisions have much broader applicability than those specific situations giving rise to the perceived abuses and the far reaching nature of the proposed corrective measures may have serious unintended consequences. Secondly, in some instances, the bill attempts to fashion remedies for perceived abuses in situations where there already exist adequate safeguards. Finally, some provisions of the bill are premature in that corrective legislation has already been passed and will take effect in the near future. For the foregoing reasons, we strenuously object to the provisions of H.R. 6295. Our specific objections are more fully discussed below.

H.R. 6295 is overly broad in that it attempts to deal with perceived abuses arising from the interplay of the consolidated return regulations and the partial liquidation sections of the Code by limiting the partial liquidation Code provisions. Obviously, the partial liquidation provisions of the Code have far broader applicability than those situations merely involving corporate takeovers.

Congressman Stark believes that the provisions of Title II of the bill would discourage corporate takeovers "motivated by unwarranted tax advantages". Section 201 of the bill makes provision for an election treating the purchase of the stock of a corporation as if the corporation had sold all of its assets. The acquired subsidiary is deemed to have sold its assets, liquidated and then reincorporated, with the effect that its tax attributes are terminated. We believe that this highly artificial and contrived statutory scheme is unnecessary in light of the existing provisions in the Code and regulations designed to deal with trafficking in tax attributes, such as Code Sections 269 and 382, and the consolidated return regulation restrictions. These Code and regulation provisions already provide adequate safeguards.

Section 202 of Title II exacts a toll charge for any basis step-up received by the purchaser in an acquisition. This is effected by enumeration of the following two principles. The first is that the cost for a step-up in basis for an acquired corporation's assets is complete recapture, with no deferral, of items such as investment tax credits, past depreciation or intangible drilling costs. The second principle is that a distribution of assets by an ongoing corporation may result in a basis step-up only if all gain, not merely recapture items, is recognized. These principles are intended to be explicit rules of law overriding the provisions of existing law, including the consolidated return regulations to the extent they would otherwise permit deferral of recapture or gain recognition. This approach is drastic because of its scope and the possible unintended consequences that may result. The imposition of the foregoing toll charge, furthermore, may not have the effect intended by this legislation. We believe that the economics of the market place are such that sellers facing recapture will substantially pass the increased tax costs on to purchasers. The purchasers, consequently, will receive an even higher basis in the assets, which will entitle them to greater tax benefits as a result of increased accelerated depreciation and higher investment tax credits.

The provisions of Title III of the bill are intended to "simplify and improve" the tax rules dealing with net operating losses and credit carryovers in acquisitions. The rules in Title III are intended to supplant the existing provisions of Section 382 as well as the proposed revisions to that section. We believe that these proposals are premature in that the amendments intended to strengthen Section 382 have not yet become effective. Congress has delayed the implementation of the revised Section 382 regulations due largely to widespread criticism on the grounds that even these proposed regulations are overly restrictive and unnecessary.

Section 302 of Title III of the bill would limit the definition of an "F" reorganization to a mere change in identity, form or place of organization of a single corporation. We believe that this is unduly restrictive. In many instances a single integrated business is structured so as to operate through multiple corporations, for example, the separate incorporation of each outlet in a commercial retail chain. There would appear to be no reason to deny "F" reorganization treatment to such single integrated businesses.

In view of the foregoing considerations, we believe that H.R. 6295 is ill-advised. It is too broad, and attempts to fashion simple remedies for problems arising out of complex commercial transactions. It therefore will likely have far reaching and unforeseen consequences. Furthermore, the bill eliminates entire provisions of the Code which have been found to be necessary and desirable.

Respectfully submitted,

THOMAS P. MALETTA, *President.*

STATEMENT OF BERNARD WOLFMAN, FESSENDEN PROFESSOR OF LAW, HARVARD LAW SCHOOL

This statement is addressed to the dubious effort that has been made by some takeover targets to tailor asset dispositions to a pattern designed to defeat the capital gains tax that the law imposes on sales of assets by ongoing corporations. If legislation is enacted with respect to this issue, it is important to make clear that existing law rejects the evasive devices some taxpayers have used under the cover of Section 311(d) (2) (B) of the Code.

This statement is submitted on my own behalf and not on behalf of a client or Harvard Law School. In the recent past, however, I served in a judicial proceeding as an expert witness, there retained by Whitaker Corporation in litigation against Brunswick Corporation. In that connection I had occasion to prepare the attached affidavit which sets forth my understanding of existing law. If new legislation is to emerge on this subject, equitable and coherent tax policy call for confirmation and codification of current law as described in that affidavit.

STATE OF ILLINOIS, COUNTY OF COOK

Bernard Wolfman, being duly sworn, deposes and says:

1. I am Fessenden Professor of Law at Harvard University, and a copy of my curriculum vitae is attached.

2. I have examined the agreement dated February 13, 1982 between Brunswick Corporation ("Brunswick") and American Home Products Corporation ("AHP") (the "Agreement"). I have also examined the Escrow Agreement, dated February 13, 1982 between Brunswick and AHP, AHP's Offer to Purchase and Brunswick's letter to shareholders dated February 16, 1982. In form, although not in substance as I will indicate below, they call for AHP to make a tender offer for up to 14,166,666 shares of Brunswick common stock at $30 per share, or an aggregate sum of $425 million. By mutual agreement of the parties, the per share purchase price payable by AHP in the tender offer can be increased, provided that the number of Brunswick shares to be purchased are reduced proportionately so that AHP will not pay more than the $425 million specified in the Agreement. At a closing provided for in the Agreement, Brunswick will redeem its outstanding shares acquired by AHP, paying for those shares by distributing the stock of designated subsidiaries (the "Medical Stock") to AHP. Thus, AHP will have acquired the Medical Stock which it seeks for the $425 million which it is prepared to pay without regard to the number of Brunswick shares actually purchased with that sum.[1]

3. In substance, the Agreement and Offer to Purchase provide for the following transaction:

(1) AHP is to pay $425 million in cash for the "Medical Stock";

(2) Effectively, the cash will be employed by Brunswick to redeem shares of its outstanding common stock at a per share price that, in the aggregate, will total the $425 million purchase price.

4. It is my opinion that upon audit of Brunswick's income tax return for the year 1982, the Internal Revenue Service will view the substance of the transaction as I have described it above and treat the transaction as Brunswick's sale of the Medical Stock to AHP for a cash payment of $425 million, followed immediately by a distribution of the purchase price to the Brunswick shareholders in redemption of outstanding shares worth a total of $425 million. With that view the Internal Revenue Service would conclude that Brunswick realized a taxable gain equal to the difference between its tax bases in the Medical Stock and $425 million. It is a highly probable that the courts would sustain that conclusion.

5. My opinion is based on general principles of federal income tax law, court decisions in analogous situations, and in particular on the position enunciated by the Internal Revenue Service in Rev. Rul. 80-221, 1980-1 C.B. 107.

6. Section 311 of the Internal Revenue Code provides that in certain circumstances a coproration will not recognize gain when it distributes appreciated proper-

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[1] The Agreement also provides that under certain conditions AHP has the option to purchase directly the Medical Stock for $450 million in cash.

ty to its shareholders in redemption of its stock. That section applies only when the distribution is a guise, not a cover-up for a sale. It requires that the distribution be made to those who are the real equity investors in the distributing corporation, not to those whose title to the shares, like AHP's, would be transitory. The Offer to Purchase states that AHP will transfer to Brunswick the shares purchased pursuant to the tender offer in exchange for the Medical Stock "Substantially simultaneously" with acceptance of tendered shares. Indeed, it states that "the Offer is not being made with a view to acquiring . . . any continuing [stock] interest in the Company." A proper construction of Section 311 also requires that those who had been the shareholders of the corporation before any distribution be the people who will thereafter own and hold the asset. Under the Agreement, however, the shareholders will have received cash, and the asset will be in the hands of AHP.

7. The legislative history of Section 311 demonstrates that it was designed to exempt corporate gain on distributions only when they were made to shareholders as such, and not in any other capacity. S. Rep. 1622, 83d cong. 2d Sess. 247 (1954). Realistically, AHP is a purchaser of assets, and it is only in that capacity that it will receive the Medical Stock.

8. The Treasury Regulations amplify and make concrete the limitations on Section 311 as expressed in its legislative history:

"Section 311 is limited to distributions which are made by reason of the coprora-tion-stockholder relationship., Section 311 does not apply to transactions between a corporation and a shareholder in his capacity as debtor, creditor, employee, or vendee where the fact that such debtor, creditor, employee, or vendee is a shareholder is incidental to the transaction. Thus, if the corporation receives its own stock as consideration upon the sale of property by it, or in satisfaction of indebetedness to it, the gain or loss resulting is to be computed in the same manner as though the payment had been made in any other property." Treas. Reg. 311-1(e)(1).

9. The strong probability that both the Internal Revenue Service and the courts will see the transaction for its substance, i.e., that AHP proposes to purchase the Medical Stock for cash, is based on a judicial mode of analysis and doctrine going back at least to *Gregory* v. *Helvering,* 293 U.S. 465 (1935), and to the Supreme Court's decision in *Minnesota Tea Co.* v. *Helvering,* 302 U.S. 609, 613 (1938), in which the Court said: "A given result at the end of a straight path is not made a different result because reached by following a devious path." *Minnesota Tea* resulted in the "integrated transaction" or "step transaction" doctrine, a cornerstone of federal tax law. *See Halvering* v. *Elkhorn Coal Co.,* 95 F. 2d 732 (4th Cir. 1937), *cert. denied,* 305 U.S. 605 (1938). The Supreme Court said in *Minnesota Tea* that it would give no credence to a "round-about process" and a "Preliminary distribution" that were but "a meaningless and unnecessary incident in the transmission of the fund. . ."*Minnesota Tea, supra,* at 613. In the instant matter, too, it is clear to me that the Agreement provides but a "roundabout process" by which the parties will do something indirectly which, done directly, would make manifest the intention of the parties to have Brunswick sell the Medical Stock to AHP in exchange for the cash with which to redeem its shareholders' stock.

10. In *United States* v. *General Geophysical Co.,* 296 F. 2d 86 (5th Cir. 1961), cert. denied, 369 U.S. 849 (1962), Judge Wisdom made clear that Section 311 may not be used to exempt a corporation's otherwise taxable gain if its application is predicated upon a transfer of ownership that is but transitory. The Agreement here provides that AHP's ownership of Brunswick stock will be only technical and momentary. For that reason, it is not at all likely that Burnswick's distribution of the Medical Stock to AHP will be a "distribution" such as to invoke Section 311. That section calls for a corporation's distribution of assets "with respect to its stock," i.e., a distribution to shareholders. In my opinion, under federal tax law AHP will be but a conduit, not a true shareholder, not an investor in stock subject to market and other risks. Indeed, the Internal Revenue Service has ruled that a taxpayer's temporary stock ownership will be "disregarded"as "transitory and without real substance." Rev. Rul. 63-234, 1963-2 C.B. 148, this on the authority of *Helvering* v. *Bashford,* 302 U.S. 454 (1938).

11. In *Idol* v. *Commissioner,* 38 T.C. 444 (1962), aff'd, 319 F. 2d 647 (8th Cir. 1963), the courts analyzed a transaction substantially identical to that posed in the instant Agreement. The Tax Court, following the step transaction doctrine, treated the distribution of a corporate asset as a sale, and the Eighth Circuit, in an opinion by Justice (the Judge) Blackum affirmed. [In Idol, the Tax Court distinguished its earlier decision in *Standard Linen Service, Inc.,* 33 T.C. 1 (1959), because in that case the record showed "clearly" that it was the individual shareholders who had initiated the transaction for the sale of their shares. Moreover, Standard Linen Service was decided under the 1939 Code, which did not contain a specific section like Section

311 mandating that a corporation's distribution be "with respect to its stock."] Rev. Rul. 80-221, supra, the Internal Revenue Service's most recent pronouncement in this area of law, relied on *Idol* in holding that a distribution of property involving a "transitory interest," not "normal shareholder interest," will prevent the invocation of the exemption provision of Section 311. *See also, Bush Brothers and Company* v. *Commissioner, —— F. 2d ——, 49 Am. Fed. Tax Rep. 2d 82-481 (6th Cir. Jan. 8, 1982), aff'g* 73 T.C. 424, 440 (1979); Rev. Rul. 63-234, *supra.*

12. Depending upon the number of shares tendered pursuant to AHP's tender offer, the effective redemption of shares by Brunswick may well be substantially pro rata, in that each Brunswick shareholder will be left with substantially the same proportionate interest in Brunswick common stock as that held prior to the AHP tender offer. Under such circumstances, the cash received by tendering shareholders would probably be treated by the Internal Revenue Services as a dividend distribution, taxable to the shareholders as ordinary income, and not as a distribution which produces only capital gain.

13. The Service's position as to the tax consequences to Brunswick shareholders is presaged by the Supreme Court's decision in *United States* v. *Davis,* 397 U.S. 301 (1970), which will be applicable if the disposition of shares by Brunswick shareholders does not result in a complete termination of a shareholder's interest, in a "substantially disproportionate" reduction in a shareholder's interest, or at least in a "meaningful reduction" in proportionate interest. If the redemption fails to meet one of those tests, the distribution will be "essentially equivalent" to a dividend and taxed accordingly.

14. In the event that it is determined that Brunswick is liable for tax on its gain in the Medical Stock, interest will accrue on the corporate tax deficiency at 20 per annum under current law. The same rate of interest will accrue on any deficiency in tax asserted against the Brunswick shareholders.

15. I believe that any reputable tax counsel would conclude there is a very serious risk that consummation of the Agreement will subject Brunswick to taxation on its Medical Stock gain arising upon the disposition of the Medical Stock and, depending upon the degree to which the distribution is pro rata among Brunswick shareholders, may subject those shareholders to ordinary dividend income treatment for the consideration received in AHP's tender offer.

BERNARD WOLFMAN.

Sworn to before Notary Public this 17th day of February, 1982.

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